



Gresham Partners: Planning for Potential Tax Law Changes

Background

Now that the Democrats will control both houses of Congress and the White House, it is timely to focus on tax law changes they might propose. Although President-elect Biden and other Democrats have proposed many changes to individual income and payroll taxes, business income taxes and individual transfer taxes, we will limit this commentary to those changes that would be most likely to affect our clients and are attributable to President-elect Biden.

Given other priorities and the realities of the legislative process, it seems unlikely that tax law changes would apply retroactively to the beginning of this year. Congress has, however, previously made even mid-year changes retroactively applicable, and it is also possible that certain proposed changes could be enacted more quickly than others. Despite this uncertainty, we believe our clients should consider now how these proposed changes might affect them and whether they want to implement certain strategies sooner rather than later.

Proposed income and payroll tax changes that may require planning or action

- **Remove preferential rates for qualified dividends and long-term capital gains for taxpayers with incomes over \$1 million.** Biden has proposed taxing both long-term capital gains and qualified dividends at ordinary income tax rates if a taxpayer's income exceeds \$1 million. The 3.8% net investment income surtax would still apply, so the top federal rate paid on this income would almost double to 43.4% for affected taxpayers.

Repeal of the lower rate on long-term capital gains for high-income taxpayers would also eliminate the benefit that rate currently provides for carried interest payments attributable to capital assets held at least three years for most taxpayers who receive such payments. Consequently, investors expecting their incomes to exceed \$1 million may want to consider harvesting long-term capital gains or receiving carried interest payments as soon as possible in case the effective date of an increase in long-term capital gains rates is in 2021. Commentary on this decision is included later.

- **Increase the top rate for individuals on ordinary income from 37% to 39.6% for incomes over \$400,000.** While it is unclear whether the \$400,000 income threshold would apply to single filers, joint filers or both, taxpayers with the ability to adjust the timing of their income to keep it below \$400,000 in some years may want to consider strategies for doing so.
- **Cap the benefit of itemized deductions at 28% and restore the Pease limitations.** Placing a 28% ceiling on the benefit of itemized deductions – including charitable contributions, mortgage interest expense and maybe state and local taxes currently capped at \$10,000 – would increase the effective tax rate for certain high-income taxpayers. For example, assuming the Alternative Minimum Tax does not apply (but recognizing it may apply in the future to more taxpayers than it does currently), a high-income taxpayer subject to the 39.6% rate who makes a charitable cash donation would pay tax on income used to fund this donation at a rate of 39.6%

but receive a deduction at a rate of only 28%. This would constitute an 11.6% tax on the income that was earned but then donated.

Restoring the Pease limitation would reduce some itemized deductions by 3% for every dollar of taxable income above a certain threshold, possibly subject to some minimum level of allowable deductions. This change would increase the tax on charitable deductions made from income that is described above.

Accordingly, taxpayers should consider making 2021 charitable contributions early in 2021 in case the effective date for these changes is later in 2021. For taxpayers who have not identified a specific cause or charity to support, a donation to a donor advised fund is worth considering, although the AGI limitations are lower for such donations.

- **Expand the Social Security (FICA) tax to earnings above \$400,000.** This change would impose a 12.4% tax on Social Security wages and self-employment income on amounts exceeding \$400,000 and create a “donut hole” with no Social Security tax payable on wages and self-employment income between \$142,800 (for 2021) and \$400,000.
- **Repeal the Tax Cuts and Jobs Act of 2017 (TCJA).** Biden has expressed general support for this repeal, but he has not specified exactly what he means by this support. Such a repeal could result in higher individual income tax rates at multiple levels of income, a reduction of the Alternative Minimum Tax thresholds and elimination of the 20% deduction for qualified business income, REIT dividends and income from publicly traded partnerships. It could, however, also result in the elimination of the \$10,000 cap on the itemized deduction for state and local taxes.
- **Eliminate some favorable tax treatments provided to real estate, such as Section 1031 exchanges, for taxpayers with incomes above \$400,000.** The uncertainty noted above regarding this \$400,000 threshold applies to this proposed change as well. Owners of real estate who are contemplating Section 1031 transactions may want to consider accelerating them in case the effective date for these changes is sometime later in 2021.
- **Increase the corporate income tax rate from 21% to 28% (or 35% if the TCJA is repealed) and apply some tax scheme to corporate book income.** These approaches to increasing corporate taxes could impact corporate stock prices.

Potential acceleration of income subject to current long-term capital gain rates

Many factors impact the decision whether to accelerate income subject to long-term capital gains rates beyond the potential that it will be subject to a lower rate if it is realized before the effective date of an increase in those rates. These additional factors include when the income would otherwise be realized, whether the acceleration will result in a lower amount of proceeds being received, whether accelerating the income will permit a change in how the after-tax proceeds are invested and when or whether the gain is expected to be eliminated by a step-up in income tax basis realized upon someone’s death.

We have developed a model to help our clients with this analysis. Results are highly dependent upon the assumptions used, making it difficult to provide generally applicable guidance. However, our analysis of several scenarios leads us to reach the following conclusions:

- Clients should reconsider the decision to hold highly appreciated assets instead of selling them and paying tax if it seems likely the current rate (23.8%) would be applicable rather than a much higher rate (e.g., 43.4%). One – albeit limited – situation when accelerating the sale of an asset might be attractive is when the sale is expected to close later in 2021 or in 2022, installment sale treatment is a possibility and the sales price is not expected to increase meaningfully between now and the expected closing date. In such a situation, it could make sense to close the transaction as soon as possible in case the effective date for an increase in the rate on long-term capital gain income is in 2021 but after the closing date, and receive a small installment payment so a decision can be made as late as October 2022 whether to tax all the gain or only the initial installment in 2021.
- The likelihood of receiving a step-up in income tax basis at death in the not-too-distant-future has been a major consideration in some decisions to retain highly appreciated assets. Given the potential elimination of such a step-up in basis (described below), this consideration may deserve less weight in the future.
- Investment considerations should continue to be given significant weight in decisions regarding when to liquidate appreciated assets.

Proposed transfer tax changes that may require planning or action

Repeal of the TCJA and the resurrection of proposals made or considered during the Obama/Biden administration would significantly change the current transfer tax landscape. Although the structure and effective dates of any such changes are unknown, they have the potential to substantially constrain currently available wealth transfer strategies. Here are potential changes that we believe deserve attention.

- **Decrease the current unified (gift, estate and generation-skipping transfer) tax exemption.** Repeal of the TCJA would reduce the per-person unified transfer tax exemption as indexed for inflation from its current level of \$11.7 million to \$5 million (or approximately \$5.5 million if some version of inflation-adjusted indexing were applied). Some have speculated that new legislation could reduce the exemption even further, possibly to the \$3.5 million level previously proposed by the Obama/Biden administration. This potential change should motivate clients with larger estates to consider utilizing their full exemption(s) as soon as is practicable. Clients who had fully utilized their exemptions as of the end of last year can still make use of the additional \$120,000 that inflation adjustments added as of January 1, 2021. Certain strategies may permit transfers made early in 2021 to be modified later if it is determined that they occurred after the effective date of a decrease in the exemption.
- **Increase the current unified transfer tax rate.** The current rate of 40% would not be impacted merely by repeal of the TCJA. Although Biden has not advocated for a rate increase, the prospect of one reinforces the importance of utilizing currently available transfer tax exemptions and potentially even making taxable gifts to fully utilize a generation-skipping transfer tax exemption that exceeds an available gift tax exemption.
- **Eliminate the step-up in tax basis at death.** Under current law, appreciated assets included in an estate receive an income tax basis step-up to their date-of-death value or their value six months later. Biden has made an alternative proposal. It is unclear whether this change would be limited to carryover basis for inheritors or

involve a more drastic change that would impose an income tax on appreciation at death. A carryover basis approach was actually enacted in 1976, but implementation of it proved to be so difficult it was repealed before it took effect. Although this change seems unlikely in the near-term, its possibility can't be totally ignored.

- **Bring back proposed restrictions on valuation discounts.** The Obama/Biden administration issued proposed regulations in 2016 that would meaningfully restrict the use of fair market value discounts when assets transferred are subject to lack-of-control, marketability or other restrictions. These proposed regulations were withdrawn in 2017, but it seems likely some version of them will return under the new administration. This prospect provides additional incentive to consider as soon as possible any wealth transfer strategies to which a valuation discount may apply.
- **Impose restrictions on the use of grantor retained annuity trusts (GRATs) and generation-skipping trusts.** Other potential changes include restricting the design and funding of GRATs and the duration of generation-skipping trusts. The potential for these changes makes it important for anyone considering a GRAT strategy or putting generation-skipping trusts in place to do so as soon as possible.
- **Change grantor trust status.** If ordinary income tax rates and rates on long-term capital gains for high-income taxpayers are increased, families with grantor trusts should consider whether the benefit of terminating grantor trust status – if those trusts will qualify for lower tax rates – exceeds the benefit of having the income tax payments decrease the grantor's taxable estate.
- **Modify trusts producing meaningful amounts of taxable income.** If income tax rates on ordinary income or long-term capital gains are increased for high-income taxpayers, trustees or other fiduciaries with the authority to do so should consider dividing individual trusts into multiple smaller trusts if they will qualify for lower income tax rates.

A recording of a Gresham presentation on September 17, 2020, in which additional wealth transfer planning strategies were discussed can be accessed [here](#). An accompanying piece in which those strategies are described can be accessed [here](#).

Please contact your Client Advisor or another Gresham team member if you would like to discuss items mentioned above or other tax planning strategies.

This material contains information and comments on tax and legal issues and developments of interest to our clients and friends. The foregoing is not a comprehensive treatment of the subject matter covered and is not intended to provide legal or tax advice. Readers should seek legal and tax advice before taking any action with respect to the matters discussed herein.