Year-end tax planning thoughts for an uncertain political world

With tax laws in a state of flux what planning strategies should you consider?

With Vice President Joe Biden's declared victory for the Presidency but control of the Senate still in question, you may be asking yourself are there any planning steps you should be taking now? While the outcome of the post-election drama is impossible to predict, let's consider what tax saving strategies may make sense for you either before year-end or for 2021.

We have highlighted below some of the proposed tax law changes from the Democratic campaign platform as compared to current law that would most impact high net worth taxpayers and provided several potential planning strategies to think about. But first let's give some consideration to what we still don't know, because your personal thoughts and predictions about potential post-election outcomes will be a driving force in your decision making and planning discussions with your advisors.

While the outcome will not be official until recounts are complete and legal challenges are resolved, most major news organizations have declared a Biden victory for the Presidency. The Democrats also have retained a majority in the House though slimmer after losing several seats. Depending upon possible recounts, the center of the political universe will now be in Georgia where control of the Senate will hinge on two runoff elections. Democrats would need to win both seats to create a 50-50 split between the parties with the tie-breaking vote held by Vice President elect Kamala Harris assuming no change in the Presidential election results.

If Republicans retain control of the Senate, the prospects for major tax law changes should be off the table absent any party defections which seems unlikely—so the status quo when it comes to taxes would for the most part be the norm. But it is always possible we could see some bipartisan compromise on economic recovery and stimulus legislation that might include modest tax increases to offset ever increasing national debt levels.

If the Democrats take tie-breaking control of the Senate, there will likely be some moves to enact parts of the Biden tax platform especially those favorable to lower income taxpayers. But significant tax increases may be more challenging to implement given the expected need for complete unanimity amongst party members. There may also be some reluctance to immediately raise taxes while the economy is still fragile and trying to recover. Accordingly, while a key message of the Biden campaign was repealing the tax cuts included in the Tax Cuts and Jobs Act of 2017 ("TCJA"), the road from campaign messaging to actual legislation often takes a long and winding path with more than a few detours. So even if Democrats win the Senate it remains to be seen what provisions of the TCJA may still survive at least until its scheduled expiration date at the end of 2025.

The other big unknown is timing for any new tax legislation. Would a new Congress look to make any tax law changes retroactive to January 1, 2021, thereby potentially limiting the ability to take a wait and see approach and delay implementing any planning strategies until there is more clarity on where future tax legislation is heading?

It seems possible that certain tax reduction changes such as reinstating the unlimited state and local income tax deduction may be made retroactive to January 1. But a retroactive tax rate increase of any magnitude, even if limited to only the wealthiest of taxpayers, may be unpopular with some Democrat legislators. Nevertheless, there are historical precedents for retroactive tax rate increases (especially in the estate & gift tax area) and some past proposals have had effective dates retroactive to when first announced, introduced, or approved by a tax-writing committee. So delaying taking proactive steps now to reduce your tax exposure is not without some inherent risk of being too late to the game and losing a valuable planning opportunity.

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Income tax planning: strategically time your income and deductions

Accelerating income and deductions rarely go hand-in-hand. But depending upon your personal financial circumstances and the timing of any future tax law changes, some of the Democratic tax proposals could make it advantageous for you to accelerate both more income and more deductions before year-end.

If that is not feasible for you for this year, consider these same strategies in 2021 if any future tax law changes have a delayed effective date to 2022.

Conversely, if you are currently unable to itemize your deductions it may be advantageous to delay certain tax payments and charitable contributions until 2021.

Here are some projected changes and related strategies to consider—with the caveat that we suggest always being cautious in accelerating income in anticipation of tax increases that at least at this point seem uncertain to happen immediately:

Taxpayers with more than $1,000,000 of income could see the top rate on qualified dividends and long-term capital gains increased from 20% to 39.6%.

- Consider recognizing capital gains in 2020 by selling substantially appreciated assets if you will otherwise be selling those assets in 2021 and potentially be subject to the highest tax bracket on gains.

Taxable income in excess of $400,000 could be taxed at 39.6%.

- Consider accelerating IRA distributions to fill lower tax brackets this year and if not desired for cash flow use these extra net after-tax distributions for a Roth conversion.

Charitable contribution deductions could be limited to 28% for high income taxpayers.

- Consider bunching your charitable donations into 2020 if your normal deduction is greater than 28%.
- You can establish and make gifts to a donor advised fund to obtain an up-front charitable deduction this year and then spread donations to your favorite charitable organizations over future years.
- Looking forward, if you are older than 70½ consider making qualified charitable distributions (up to $100,000 per year) from your IRA rather than taking Required Minimum Distributions if your charitable deductions will otherwise be limited to 28%.

If the TCJA is repealed, the previous lower standard deduction amounts could be reinstated causing more taxpayers to itemize their deductions.

- If you are currently unable to itemize your charitable deductions, consider delaying your donations into early next year when they may become deductible.

The $10,000 deduction limitation for state and local income tax (SALT) payments (including real estate taxes) could be eliminated and an unlimited SALT deduction could be reinstated for taxpayers who itemize their deductions.

- Defer real estate tax payments to 2021 if you are currently unable to deduct those payments.

	Current Law	Democratic Platform	Planning Considerations
Tax rates and brackets	• Top bracket is 37% for incomes over $622,000 married filing joint and $518,000 for single filers.	• Restore top marginal tax rate to pre TCJA rate of 39.6% applicable to taxable income over $400,000. Effectively eliminates the current 35% and 37% tax brackets.	• Accelerate income to 2020/defer expenses to 2021. • Consider non-traditional, tax-advantaged sources of retirement income like life insurance with tax free cash value build up. • Consider a Roth IRA conversion to take advantage of today's lower rates.
Itemized Deductions	• Value of itemized deduction is the top marginal tax rate of 37%. • State and local tax deduction is limited to $10,000.	• Caps the value of itemized deductions to 28%. • Removes deduction limitation for state and local taxes.	• If potentially subject to the 28% cap, accelerate itemized deductions, such as charitable deductions, into 2020 to get a greater tax benefit from these deductions.
Capital gains and dividends	• Maximum capital gains and qualified dividends tax rate is 20%. • Nonqualfied dividends are taxed at ordinary rates. • 3.8% net investment income tax (Medicare surtax).	• Tax capital gains and qualified dividends at top marginal rate of 39.6% if over $1,000,000 of total taxable income. • Eliminate like-kind exchanges for taxpayers with incomes over $400,000.	• If potentially subject to the 39.6% rate, consider selling appreciated capital assets in 2020 if you have already identified potential sales (including a business, real estate, concentrated stock positions, etc.). Harvest capital losses to carry forward against future large capital gain years.

Payroll taxes	• No payroll tax on income above $137,000.	• Payroll tax of 12.4% on wages over $400,000—split between employers and employees.	• For business owners:
			  • Consider how salary/distributions are allocated from your business to reduce payroll tax/income tax exposure.
			  • Consider choice of business entity.

Estate taxes: utilize the life-time estate and gift exemption

The TJCA increased the estate, gift, and generation skipping tax exemption amount by an extra $5 million per person (current exemption amount is now at an historic high of $11.58 million). The Biden tax proposal would reverse the exemption amount back to the pre TCJA level of $5.49 million ($5 million indexed for inflation).

Some political commentators have suggested an even more drastic reduction in the exemption amount to as low as $3.5 million which was the exemption in 2009. Estates in excess of the exemption amount will be subject to a 40% estate tax assuming the rate is not increased to prior levels which have historically been as high as 55%.

Bottom line is this could be a "use it or lose it" situation when it comes to utilizing the full $11.58 million exemption. It is also important to note that the IRS has issued a ruling that it will not "clawback" and tax large gifts if the estate tax exemption amount ever reverts back to the prior lower thresholds.

Keep in mind that you will only benefit from the anti-clawback provision if you make a gift that is in excess of the estate exemption amount in effect at the time of your death. For example, if you make a gift valued at $11 million in 2020 and the estate tax exemption amount at your death is only $6 million the IRS will still treat you as having had an $11 million lifetime exemption meaning you will have benefited from using the extra $5 million exemption amount during life. Conversely, if you were to make only a $3 million gift now you will receive no benefit from the enhanced exemption amount because you will be treated as having only a $3 million exemption amount remaining at your death ($6 million lifetime exemption in effect at death less $3 million used during life). Essentially the IRS has decided to apply a first in/first out rule when it comes to the estate tax exemption meaning that they will first assess any gift you make against your pre-TJCA exemption amount and only after that is exhausted will they apply any excess amount to the new TJCA $5mm exemption increase.

For business owners, its also important to remember that in 2016 during the final year of the Obama administration the IRS was in the process of finalizing tax regulations that would have eliminated valuation discounts for gifts of interests in family-controlled entities. It is not inconceivable that these regulations could be revived by the Biden administration and if enacted would eliminate the valuation leverage obtained when making gifts of noncontrolling equity interests in family owned businesses.

So with the possibility of valuation discounts once again coming under regulatory scrutiny, making gifts now of interests in a family owned business may be especially valuable. For more guidance on estate tax planning strategies for business owners see our recent update *The Time is Right for Family Equity Transfers.*

If you are a business owner, you may also want to review your current life insurance planning to ensure your family will have enough liquidity to pay any future estate taxes related to your business. If you have a potential estate tax exposure, your life insurance should be held in an irrevocable life insurance trust ("ILIT") so the death benefit is excluded from your taxable estate. If you have an existing ILIT or will be putting one in place to acquire new life insurance, you may want to consider using part of your estate tax exemption to fund the ILIT with cash or business interests to provide a source of funds for future premium payments.

For married couples who are considering making large gifts to utilize their exemptions prior to any potential law changes, one strategy to consider is transferring assets to an irrevocable spousal lifetime access trust ("SLAT"). With a SLAT, a spouse can be included as a beneficiary along with other family members and receive distributions without causing estate tax inclusion. With proper structuring to avoid having the trusts being considered reciprocal, you and your spouse could establish SLATs for the benefit of each other and provide for trust distributions to be made if needed to help support your accustomed manner of living.

	Current Law	Democratic Platform	Planning Considerations
Estate, gift and generation-skipping tax exemptions	• Estate, gift and generation-skipping tax exemption is $11.58 million per individual until 2026 (sunsets after 2025).	• Lower the estate, gift and generation skipping tax exemptions to pre-TCJA level of $5.49 million ($5 million indexed for inflation). Possible that exemption could be reduced even more to prior level of $3.5 million.	• Make lifetime gifts to take advantage of the generous $11.58 million exemption. This will also remove future appreciation from your estate now, enhancing the value removed from taxes and given to heirs.
"Step-up" in basis	• Capital assets of deceased receive a "step-up" in basis to fair market value at date of death for inheritor.	• Remove the "step-up" in basis for inheritor. Instead, inheritor would have carryover basis equal to the deceased's basis at their death.	• Consider shifting low basis assets to irrevocable trusts and out of taxable estate. • Gift low basis assets to charity and high basis assets to heirs.

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Corporate taxes: review choice of entity

A primary focus of the Democratic campaign platform was reversing the TCJA's corporate tax rate cut and proposing a new corporate tax rate of 28%. If enacted this tax rate increase and other proposed changes to corporate taxes may emphasize the importance of choice of entity decisions by business owners. To the extent possible, businesses may also want to accelerate income into this year and delay paying deductible expenses until 2021.

	Current Law	Proposals: Biden/Democrats	Planning Considerations
Corporate tax rate	• Corporate tax rate is 21%.	• Increases corporate tax rate to 28%.	• Shift income into 2020 to take advantage of lower corporate tax rates. • Shift expenses into 2021 to take advantage of a greater offset with higher corporate tax rates. • Consider your choice of business entity and tax implications (for both corporate and individual with a flow through entity such as an S corporation, LLC, LP).
Minimum tax	• Minimum tax was repealed.	• Impose a 15% tax on book income (for corporations with greater than $1 million of income).	• Consider your choice of business entity and tax implications (for both corporate and individual with a flow through entity such as an S corporation, LLC, LP).
Deduction on Qualified Business Income	• 20% pass-through deduction on qualified business income (subject to thresholds).	• Eliminate 20% pass-through deduction for taxpayers with income over $400,000.	• Consider your choice of business entity and tax implications (for both corporate and individual with a flow through entity such as an S corporation, LLC, LP).

Planning considerations for future tax law changes should be evaluated as part of your overall wealth plan.

Be sure to review your options with your tax advisor to assess what strategies might be optimal for you in light of your entire financial situation.

We'll continue to monitor ongoing legislative developments in Washington and assess what any changes may mean for our clients.

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