Planning Strategies

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Update on Possible Tax Changes in 2021

The following is a summary of recently released tax proposals by President Joe Biden as well as other Democratic leaders. It is important to remind ourselves that these are proposals and that their chance of passage is uncertain. Nonetheless, we do anticipate that the United States is entering an era of higher taxes. The most effective planning will be that which is accomplished before the effective date of any new taxes. However, there is a saying that the "tax tail should not wag the dog." Even though tax rates may be increasing in 2022, that alone may not dictate doing anything now. Other factors need to be considered and a holistic approach is best. One of the hallmarks of 1919 Investment Counsel is our belief that each client is unique. A one-size-fits-all approach will not work for everyone. We encourage you to contact us with your questions and concerns.

– Harry O'Mealia, CEO

On March 3, 2021, we issued the attached white paper entitled **Tax Changes under the Biden Administration**. We said, "As a candidate for president, Joe Biden promised to increase taxes on the wealthy, and all Democratic candidates did so as well." We also stated that, as of the date of the article, no firm legislative proposals had been introduced to increase taxes but that we expect they are coming. After that paper was published, President Biden (as well as other Democratic leaders) introduced a string of proposals to increase taxes on the "top one percent." Below we review the proposals in the White House's "American Families Plan" and a few others. Other than disagreeing with many elements of the Biden proposals, there has not yet been a synchronized Republican counterproposal. However, we expect that as legislation is negotiated, some of the provisions will be tweaked and made more moderate. There is a difference between taxes as revenue-raising measures and taxes as wealth redistribution measures. We expect Republicans and moderate Democrats to push back much harder on the latter.

It is currently difficult to say what will and will not pass. A number of factors are in play. While most of these proposals are merely that and will not become law in the near future, some will be enacted in one form or another. The provisions that are the easiest to enact (such as a higher tax rate) or which attack obvious tax loopholes (GRATs, carried interest exception, e.g.) are the lowest hanging fruit. We don't think that a complex revamping of the U.S. tax system, such as a federal wealth tax or a deemed realization at death, is likely to pass (although President Biden's plan calls for a capital gain realization at death). Moreover, many lobbying interests, such as the insurance industry, will be quick to pounce on proposals they don't like (such as limits on annual exclusion gifts) and attempt to advance their own agenda. In addition to federal tax increases, some highly populous states are looking for new sources of tax revenue and are getting creative. On top of all this, we expect a new era of aggressive tax enforcement. The word on the street is that the IRS is hiring.

The President's American Families Plan

On April 28, 2021, in advance of the President's address to Congress, the White House released a Fact Sheet on the American Families Plan. In terms of income tax increases on individuals, President Biden's plan calls for:

- Increasing the top tax rate on ordinary income to 39.6%
- Increasing tax rates on capital gains and qualified dividends: the plan would increase the top rate on capital gains to 39.6% for households earning over $1 million (We believe that irrevocable trusts and estates would owe tax at this rate at a much lower threshold than they do now)
- Eliminating tax-free step-up in basis at death by imposing a deemed capital gains tax at death with a $1 million exemption ($2.5 million for a married couple)
- Ending the carried-interest loophole for hedge fund and private equity partners
- Limiting the exclusion for section 1031 like-kind exchanges of investment real estate to no more than $500,000 of capital gains
- Imposing a 3.8% Medicare tax on all unearned income for persons with income over $400,000. (Today, this tax too applies to trusts at a much lower threshold)
- Increased tax enforcement by the IRS
- Increase in corporate income tax rate from 21% to 28%

The "For the 99.5 Percent" Act

The White House's plan is not yet in the form of proposed legislation but is merely a "plan." Curiously, despite President Biden's campaign promises, this plan did not include any mention of a lower estate tax exemption or an increase in estate tax rates. However, a recently released plan by Senator Bernie Sanders on March 25,

dubbed the "For the 99.5 Percent" Act, was released in the form of actual legislative text, and calls for major changes to the estate, gift and Generation-Skipping Transfer (GST) taxes:

- A reduction of the $11,700,000 estate tax exemption to $3,500,000
- A reduction of the gift tax exemption to $1,000,000
- An increase in the estate tax rate from a flat 40% to a progressive rate as follows:
    - 40% on the first $3,500,000 of the taxable estate
    - 45% on the next $6,500,000
    - 50% on the taxable estate over $10,000,000
    - 55% on the taxable estate over $50,000,000, and
    - 65% on everything over $1,000,000,000
- Eliminates valuation discounts for non-business entities used for planning purposes such as Family Limited Partnerships. (There are 2016 regulations on the books already that do this, but they were shelved in 2017)
- Treats new grantor trusts as owned by the grantor for estate tax purposes, thus subjecting them to estate tax, thereby eliminating the "sale to the defective grantor trust" strategy
- Eliminates stepped-up basis at death for grantor trusts regardless of when created (although this was not widely viewed as an issue)
- Curtails the efficacy of Grantor Retained Annuity Trusts (GRATs) as a strategy to transfer wealth tax-free by requiring a 10-year minimum term and a 25% remainder (proposed in 2016 as well)
- Imposes a Generation-Skipping Transfer (GST) tax every 50 years at a flat rate of 65% (highest estate tax rate in effect)
- Caps the annual gift exclusion to a total of $30,000 for certain gifts, such as gift to trusts, family entities, or assets subject to restrictions on sale or liquidation (a version of this was proposed in 2016 as well; would limit *Crummey* trusts and life insurance trust planning)

Some of these provisions would be effective on January 1, 2022 while others would be effective as of the date of enactment. None of Sanders' proposed tax changes would take effect retroactively. It's worth pointing out that almost no one would actually pay estate taxes at the 65% rate since very large estates almost always leave a significant legacy to charity (such as a private foundation). And, as indicated, some of these ideas are not new. They have been proposed before and tabled.

In addition to federal taxes, state estate taxes may also apply to a decedent's estate depending on state of residency and the location of real assets. Under the Bush era estate tax reforms in 2001, the credit for state death taxes was replaced with a deduction. This change, in effect, stacked applicable state taxes on top of federal taxes for an overall higher effective tax rate. Twelve states and the District of Columbia impose a state estate tax. Six states have an inheritance tax (only Maryland has both).

The STEP Act

A third plan was introduced on March 30, 2021, by Senator Chris Van Hollen of Maryland, called the "Sensible Taxation and Equity Promotion (STEP) Act." Under this income tax proposal,

- Capital gains would be recognized on appreciated assets transferred by gift, by a distribution from a trust, and upon death, subject to limited exceptions
- At death, an exemption of $1 million would be allowed
- During life, the exemption would be $100,000, cumulative
- Transfers to a charity, spouse, or revocable trusts would be exempt

- All non-grantor trusts would have to report a gain on all of their appreciated assets every 21 years, and any trust formed before 2021 would have to report this gain in 2026

- Trusts over $1 million (or having more than $20,000 of revenue) will have to report to the IRS on the names, addresses and tax ID numbers of their grantors, trustees, and beneficiaries as well as provide appraisals of their assets

- The bill would be retroactive to the beginning of 2021 (a companion House bill, introduced by Rep. Pascrell of New Jersey, would take effect in 2022)

The STEP Act effectively repeals stepped-up basis at death and carry-over basis for gifts by triggering automatic gain realization on these events. The STEP Act would make the US tax system similar to the Canadian tax system, which taxes appreciation at death. The tax rate would be at the highest bracket given the$1 million exemption level. Further, the Net Investment Income Tax of 3.8% could also apply. When someone dies, there could be both an estate tax and a deemed capital gain. In that case, the income tax on the deemed gain should be allowed as an estate tax deduction, but that remains to be seen. It will be difficult to plan around the deemed capital gains tax. One way could be to realize capital gains in increments yearly to avoid triggering the highest tax rate in any one year. However, this will be impossible for trusts that pay taxes at the highest bracket, which they reach at a very low threshold (only $13,050).

The STEP Act would represent a major shift in US tax policy and how the tax system works. There also may be constitutional issues with it. For example, imposing a tax on capital appreciation at death may not be consistent with the 16th Amendment, which gave Congress the power to "lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The Wealth Tax

On March 1, Senator Elizabeth Warren (Mass.) proposed a new "Ultra-Millionaire Tax" Act, commonly known as the "wealth tax." No such tax currently exists at the federal level. The closest cousin to the wealth tax is the state-level real estate tax.

The "Ultra-Millionaire Tax" Act would impose an annual wealth tax of:

- 2% on the net worth of households and trusts between $50 million and $1 billion
- 1% surtax (3% tax overall) on the net worth of households and trusts above $1 billion

The wealth tax would apply annually to individuals and trusts with wealth above those thresholds. Married couples would be treated as one taxpayer as would trusts with similar beneficiaries. In the year of death, any estate tax due would be deductible for wealth tax purposes. However, no deduction for wealth tax due would be allowed for income tax purposes. The bill also includes $100 billion to beef up the IRS, a mandated audit rate for ultra-millionaires, a 40% exit tax on net worth above $50 million for anyone expatriating, increased reporting and new rules on the valuation of hard-to-value assets such as partnerships. The bill would also impose heavy penalties for substantially understating the amount of tax due (as much as 50% of the underpayment).

The wealth tax has gotten a lot of press but President Biden has not adopted it as part of his platform. Many lawyers believe it is a "direct tax" that doesn't pass constitutional muster because it would not be apportioned among the states by population as required by the constitution. Wealth taxes are also complex to administer. Treasury Secretary Janet Yellen has acknowledged as much in public remarks. Several countries have imposed wealth taxes only to repeal (or strictly limit) their wealth taxes due to complexity and administrative issues (notably France).

To top this off, some states have also enacted or proposed tax increases on their wealthiest residents:

- New York: Increased state income tax for incomes over $25 million (in effect)
- Washington: Proposed state-level wealth tax on wealth over $1 billion (proposed)

Eight states, however, do not tax incomes, notably Texas and Florida. Tennessee has recently abolished its income tax. These states also have no state estate tax.

SALT Deduction

Absent in any of the various proposals is a removal (or a change) of the $10,000 limit on the deduction for State and Local Taxes (SALT). However, a few Democratic members of Congress from higher-tax states, such as New Jersey and New York, have said publicly that unless the new tax package includes a lifting the SALT deduction they can't support it. This is significant because President Biden will need the support of every Democrat in Congress to enact any tax increases. The lifting of the SALT cap is a "tax expenditure," meaning that it will cost the government money to do it. This means (in a budget bill) the expense has to be paid for in some way. One idea is to increase IRS enforcement and tax collection over the next 10 years in exchange for adding back the SALT deduction.

What should I do?

It remains to be seen what will happen this year in terms of tax increases. What is clear is that tax increases are on the table and something is likely coming. Two obvious questions are (1) whether to realize capital gains now at the 20% rate, and (2) whether to make a large gift now. Additionally, the one overarching question is when will these new taxes take effect and what will the new rate be?

- We think it is premature to take a large amount of capital gains now just to lock in today's 20% tax rate. However, there could be extenuating circumstances that might support doing so (such as a known cash need)

- Making a large gift now before new estate and gift tax exemptions are changed may make sense if you can afford to use up your entire $11.7 million exemption. Unless you can do that, making a substantially lesser gift does not make much sense unless you live in a state with a state estate tax. For example, if you use only $5 million of your exemption, and the estate tax exemption is lowered to $5 million in 2022, you would not save any tax. The possible reduction of the gift tax exemption to $1 million suggests that a smaller gift may have its benefits though

- Creating a long-term GRAT in 2021 makes sense as GRATs will likely be strictly curtailed in future tax legislation (See our recent follow-up piece on GRATs)

- The reality is that any of the tax changes discussed above will have to be passed as part of a budget reconciliation bill for the next fiscal year starting October 1, 2021. Because of the arcane rules for budget acts, realities of the legislative calendar, and the sharp divide in Congress, we think it is unlikely that any new tax increases would be retroactive to January 1, 2021. Therefore, most new tax changes (to the extent they actually pass) should take effect in 2022. However, some new provisions could be effective as of the date of enactment. Because of the way the gift tax works, a retroactive or mid-year change of the exemption amount seems very unlikely. For these reasons, we encourage anyone thinking of making a large gift to do so sooner rather than later

We will continue to monitor this ever-changing situation and will update you periodically as clarity develops. We invite you to discuss these issues with your Portfolio Manager or Client Advisor, as well as your tax advisor and attorney. As the year winds down, we anticipate that attorneys will be inundated with planning requests. Getting planning done late in the year will be difficult. So, we urge you to move ahead now with these conversations if you are inclined to act in 2021.

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Warwick M. Carter, Jr. is a Managing Director at 1919 Investment Counsel based in New York. As a Senior Wealth Advisor, his primary focus is generational wealth planning for high net worth individuals and families. He also advises on philanthropic planning. When giving advice, Warwick takes a comprehensive approach to assessing all aspects of a client's tax, financial and family situation. Warwick works closely with Portfolio Managers and Client Advisors in all of our offices to integrate wealth strategies with a client's investments. He regularly meets with outside advisors to devise appropriate solutions that will help grow wealth in a tax-aware way over the long term.

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