The New Administration Brings Several Potential Tax Law Changes

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A new Presidential administration and Congress always bring with them the potential for change, and this is again the case. Joe Biden and his party made a series of tax law proposals throughout the presidential campaign season. He generally has proposed to increase taxes for high income individuals and to increase estate and other transfer taxes for many wealthy families. On the income tax side, these changes generally involve increasing tax rates for people with incomes over $400,000 per year and limiting the value of their deductions. People with incomes below this level have been promised that their taxes will not rise. Taxes on the transfer of wealth could increase through a reduction in the estate tax exclusion to levels as low as $3.5 million and the elimination of the step-up in basis at death.

The actual detail on these campaign pledges remains scarce and none would become law unless they are passed by both houses of Congress and signed by the President. The Senate is split 50-50 between Republicans and Democrats, with the Vice President serving as the tie-breaking vote, while the recent election narrowed the Democratic majority in the House of Representatives. This balance of power in Washington may limit Joe Biden's ability to enact major changes, but many of his key proposals are summarized below. Knowledge of these potential changes can help to identify planning opportunities that can minimize their impact should they become law.

1.

Transfer Taxes

Biden's proposed plan discusses two big changes to how transfers of wealth are taxed. First, in the words of the Democratic party platform, estate taxes would be raised "back to their historic norms." Details on what this means are few, but it could result in the reduction of the federal estate tax exclusion amount, which is $11.7 million in 2021. The exclusion could be dropped roughly by half to about $5.8 million, which already is scheduled to happen automatically without further legislation in 2026. It also could be reduced back to the 2009 level of $3.5 million. Further, some proposals include returning to a system in which the portion of the estate and gift tax exclusion that may be used during life is limited to $1 million.

Second, Joe Biden has proposed eliminating the step up in basis at death. Under current law, assets included in a decedent's taxable estate (whether valued below or above the estate tax exclusion amount) receive a new basis for tax purposes equal to their fair market value as of the decedent's date of death. This eliminates pre-mortem appreciation and can reduce or eliminate capital gains tax when the assets are sold by the decedent's executors or heirs. Biden's proposal would cause an asset's tax basis to be "carried over" from the decedent to an heir. Such a system existed briefly in 2010 but was replaced by a return of the federal estate tax in 2011. It is not clear how, if enacted, carry over basis would interact with the estate tax.

As noted above, federal law already assumes that the estate tax exclusion amount will fall in the future. Under current law, the federal estate and gift taxes share a single exclusion, and exclusion used on gifts during life is unavailable to shelter bequests at death. Thus, if a person uses $1 million of his or her $11.7 million lifetime exclusion on lifetime gifts, he or she has $10.7 million of exclusion remaining at death. A falling exclusion poses the question of what happens if a person uses more exclusion during life than exists at death. For example, if a person makes $9 million of taxable gifts during life, and the exclusion falls to $6 million before her death, what happens?

The IRS addressed this issue in taxpayer-friendly regulations published in late 2019. Under those regulations, the person's estate would be administered and taxed as if the total exclusion amount applicable at death were the $9 million used during life rather than the $6 million then available by law. The upshot of this is that individuals are not penalized for using gift tax exclusion amounts available to them at the time the gift is made even if those amounts later drop as a result of future legislation.

Certain tax changes can occur through regulations promulgated by the Treasury Department rather than through legislation enacted by Congress. Regulatory action may be a real possibility given the Democrats' narrow majority. There have been several potential changes relating to estate and gift laws in the past that never became finalized regulations. A recent example includes rules limiting valuation discounts in closely-held family business entities that were proposed in 2016 and then later withdrawn in 2017. It is possible that the Biden administration could introduce a new version of these rules.

Similarly, the Biden administration also may put in various restrictions on planning with grantor retained annuity trusts (GRATs). GRATs currently allow taxpayers to shift appreciation in property to family members at little to no gift tax cost. There have been discussions in the past of the IRS requiring a minimum annuity term of 10 years and requiring that a gift of a minimum amount be contributed to the GRAT but these have not yet come to fruition.

Clients who are concerned about potential estate tax changes should consider using their estate and gift tax exclusions now by making lifetime gifts, which can be beneficial regardless of the tax environment. Property given during life is removed from the donor's estate, as is any future appreciation on and income from that property. Clients who are especially concerned about a potential fall in exclusion amounts can consider using a technique like a GRAT ahead of any change in the rules. Married taxpayers also may consider giving techniques that allow for a trust to be funded now but permit a final decision to be put off for several months as to whether the funding will use a portion of the donor's gift tax exclusion or instead qualify for the marital deduction.

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Income Tax

Individuals

Under current law, there are seven individual income tax rates on ordinary income ranging from 10% to 37%. Joe Biden proposes to increase the top income tax rate from 37% to 39.6% for taxpayers with annual income exceeding $400,000.

The top tax rate on long term capital gains in 2021 under current law is 20% for single taxpayers with taxable income above $445,850 and for married taxpayers filing jointly with taxable income above $501,600. Qualified dividends are taxed at the same rates as long-term capital gains. Joe Biden proposes to increase the income tax rate on capital gains and qualified dividends for individuals who earn more than $1 million annually from 20% to the ordinary income tax rate of 39.6%. Such a change would effectively eliminate the rate preference for investment income over wages and other forms of ordinary income for high income earners.

Under current law, individuals may deduct the greater of the standard deduction or the sum of itemized deductions. Although different types of deductions are subject to a variety of limitations, an income tax deduction generally reduces one's tax at the taxpayer's marginal rate. For example, an individual who pays tax at the current top 37% rate and who incurs a deductible expense of $100 reduces his or her federal tax bill by $37. The Biden proposal aims to cap itemized deductions at 28% for a taxpayer with income above $400,000 even if the taxpayer's marginal tax rate is higher. In addition, the plan would restore the overall limitation on itemized deductions (sometimes known as the Pease limitation) for a taxpayer with income in excess of $400,000. The Pease limitation reduces the value of certain itemized deductions that a taxpayer can claim by an amount equal to 3% of the amount by which a taxpayer's adjusted gross income exceeds a set threshold. Accordingly, if a taxpayer's income is $500,000 and the limitation is returned with a $400,000 threshold, the itemized deductions that the taxpayer can claim are reduced by $3,000. This phaseout does not permit deductions to be reduced by more than 80%. Taken together, these limitations could very much reduce the value of a variety of deductions for high income taxpayers and increase their tax bills.

In somewhat better news, Joe Biden plans to restore the deduction for state and local taxes (SALT), which is now capped at a flat $10,000. Although a restored SALT deduction presumably would still be subject to the limits discussed above, it would still benefit individuals who reside or own property in states with high state or local income taxes or property taxes.

The proposal imposes a social security payroll tax of 12.4% on annual earnings above $400,000, to be split between the employee and the employer. Under current law, wages above $142,800 are not subject to the 12.4% social security tax. Biden's plan would keep the $142,800 threshold so that wages between $142,800 and $400,000 would not be subject to the payroll tax, forming a so-called doughnut hole. The $142,800 threshold is adjusted for inflation but it is not clear whether the $400,000 is fixed. If it is, eventually all wages would be subject to the 12.4% social security tax. Self-employed taxpayers with annual earnings above $400,000 would be required to pay the full 12.4% social security payroll tax.

Under current law, income from a carried interest may be taxed at long term capital gains rates (with a top rate of 20%), provided that the carried interest is held for 3 years or more. The special tax treatment of carried interests has often drawn political scrutiny and has recently been addressed by both Congress (in the 2017 tax reform) and the IRS. Even if the new Administration does not directly eliminate the capital gains treatment on carried interests, Biden's proposed change on the long-term capital gain rate from 20% to 39.6% for those earning more than $1 million would yield the same result by taking away a carried interest's tax benefit for many investment professionals.

Biden also plans to increase or expand various tax credits, including the Child and Dependent Care Tax Credit for individuals making between $125,000 and $400,000, the Child Tax Credit, offer certain tax credits to small businesses, and expand tax credits related to renewable energy.

Trusts

Trusts generally fall into two broad categories for income tax purposes: grantor trusts and non-grantor trusts. A grantor trust is disregarded as a separate taxpaying entity for income tax purposes and all items of income, deduction and credits from the trust are reported on the grantor's personal return whether or not the grantor is a beneficiary. A non-grantor trust is a separate taxpaying entity but it shares responsibility for taxes with its beneficiaries. A non-grantor trust typically pays taxes each year on its capital gains. Other types of income are taxable to a non-grantor trust (to the extent accumulated by the trust) or to the beneficiaries at their own rates (to the extent distributed to them).

Non-grantor trusts have their own set of tax brackets, which function like a highly-compressed version of the brackets applicable to individuals. In 2021, trusts reach the top rates for ordinary income, capital gains and qualified dividends with just $13,051 of taxable income. Changes to the top rate for individuals are generally matched by changes to the top rate for trusts so that they remain the same. Thus, a change to a 39.6% top rate for individuals will likely also apply to trusts – but at a much lower income level.

Higher trust income tax rates can make tax planning an even more important part of efficient trust administration. A grantor's payment of taxes on behalf of a grantor trust is not treated as a gift to the trust or its beneficiaries because it is the grantor's legal obligation and also allows the trust to grow income tax free. This can make grantor trust status even more valuable than it is now. For non-grantor trusts, a wide spread between the trust's tax rate and the beneficiary's own tax rate will put a premium on income distribution and efficient management of the trust's investments.

Business Income

The current corporate tax rate is 21% with no corporate alternative minimum tax (AMT). The Biden administration proposes to increase the corporate tax rate to 28% and add a 15% corporate minimum tax on corporations with income above $100 million.

Following the 2017 tax reform, taxpayers may deduct a portion of the qualified business income (QBI) from a domestic business operated as a sole proprietorship, partnership, or S corporation. These businesses generally provide for passthrough taxation. The deductible amount of QBI for each trade or business is generally equal to 20% of the taxpayer's share of the business's QBI, subject to some limitations based upon W-2 wages paid by the business and depreciable tangible property (such as real estate) used by the business. Joe Biden plans to phase out the qualified business income deduction for taxpayers with income above $400,000.

Biden also proposes less favorable treatment of income earned by U.S. shareholders of foreign corporations. It is important to speak to your tax advisor for a more in-depth analysis.

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Miscellaneous

Under current law, taxpayers can defer the payment of capital gains tax triggered by the sale of real property by exchanging real property for like-kind real property (known as a 1031 exchange). Biden proposes to eliminate the 1031 exchange for real estate investors with income over $400,000.

In addition, Biden proposes forgiving student loan debt and excluding the forgiven amount from taxation.

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Can Taxes Change Retroactively?

There is precedent for tax increase to apply retroactively, but it is uncommon. In 1994, the U.S. Supreme Court held that a retroactive tax increase does not violate Due Process if it is supported by a legitimate legislative purpose and furthered by rational means. In that case, Congress fixed a drafting error in the 1986 Internal Revenue Code a little over a year after it was enacted and faced a challenge from a taxpayer who relied (unsuccessfully) on the original version of the law. The Democrats’ narrow majorities in Congress suggest that retroactive tax increases would be unlikely.

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Charitable Planning Opportunities in 2021

At the end of 2020, Congress continued into 2021 and even expanded some special charitable giving rules that were introduced by the CARES Act in March of last year. These changes were designed to help during the COVID pandemic, passed with bipartisan support, and are unlikely to be undone by any new legislation. These rules allow individuals to claim charitable deductions substantially beyond what is normally available.

People who claim the standard deduction rather than itemizing normally cannot deduct charitable gifts. With respect to gifts made in 2021, individuals who do not itemize deductions can receive a federal deduction of up to $300 (or $600 for a joint return) for cash gifts to charities other than private foundations, supporting organizations or donor advised funds.

Individuals who do itemize are allowed to deduct their charitable gifts up to a set percentage of their adjusted gross income. This percentage differs depending upon the type of charity receiving the gift and the type of property given. For individuals who itemize deductions, cash gifts made in 2021 to charities other than private foundations, supporting organizations and donor advised funds are deductible federally up to 100% of adjusted gross income. This limitation will fall to 60% of adjusted gross income in 2022 and to 50% of adjusted gross income in 2023. This presents a substantial opportunity for individuals with the means and desire to make major cash gifts to charity this year. Other charitable giving rules generally remain the same.

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Going Forward

Time will tell how much of this becomes law, but there are still opportunities to plan ahead of any changes. Clients who wish to discuss their own particular situations and how these potential changes may impact them should consult their Private Client & Trust or Tax Attorney.