Individual Tax Planning Following the November 2020 Elections

Article
November 30, 2020

RELATED SERVICES

Tax

Trusts, Estates & Succession Planning

Following the recent November 2020 elections, individual tax planning faces further uncertainty for the remainder of this year and into the beginning of 2021. While it appears that Democrats will control the House of Representatives and the White House, under a Joe Biden presidency, it is not clear which political party will control the U.S. Senate. The nation awaits the results of the January 5, 2021 run-off elections in the State of Georgia, for two U.S. Senate seats, which will directly affect which political party has control of the Senate. Speculation regarding the legislative agenda of the incoming Congress and potential changes to tax policy, is prompting many individuals to re-evaluate how they may best utilize current tax planning tools before the end of 2020.

A Joe Biden presidency with continued Republican control of the Senate, would make it unlikely that there would be significant tax increases or significant changes in tax policy. However, a Joe Biden presidency with Democrat control of the Senate and the House of Representatives could lead to significant changes in the tax code, with potential legislation being passed in the first few months of 2021, to be retroactively effective on January 1, 2021. Accordingly, individuals may want to take actions before the end of this year, in order to utilize tax advantages that they may lose in 2021.

Taxes on Income and Capital Gains

Democrat control of both chambers of Congress under a Joe Biden presidency would likely lead to higher taxes, primarily for high-income earners and tax filers with exposure to significant capital gains. As indicated during his presidential campaign, a Biden administration would seek to impose tax increases on taxpayers with over $400,000 of income. With regard to ordinary income tax rates, the top individual income tax rate would increase from 37% to 39.6%. As it pertains to payroll taxes, additional social security taxes would be applied to wages over $400,000. Furthermore, itemized deductions would be limited to 28% on the rate against which one could take itemized deductions, and further limitations would be made for income over $400,000. Additionally, Section 199A deductions that were recently incorporated into the tax code would likely be phased out for tax filers with income over $400,000. With regard to capital investments, long-term capital gains and dividends would be taxed at ordinary income tax rates for those with taxable income over $1 million, with a potential tax rate of 39.6%.

Estate Taxes

From an estate planning perspective, Joe Biden campaigned to return the estate tax to 2009 levels which would imply a 45% tax rate (there is currently a 40% rate) and a potential exemption amount of $3.5 million per taxpayer indexed annual for inflation (there is currently an exemption of $11.58 million per taxpayer in 2020) and potentially a $1.0 million gift tax exemption. Additionally, Joe Biden's campaign proposed a full repeal of the basis "step-up" at death, which could lead to significant taxes being incurred on the gains realized by assets at the time of death or until the asset is sold (carryover basis). The repeal of the "step-up" in basis, in favor of a forced recognition event, would encourage individuals to recognize gains before death to avoid a potential 39.6% tax rate on capital gains in a future year of death, rather than the current 20% tax rate on capital gains that is in place as of 2020. However, if the "step-up" in basis at death is retained, many individuals will be encouraged to hold onto assets until death, rather than to seek out alternate investments of capital.

Strategies to Limit Exposure to Potential Tax Increases on Income and Capital Gains

Individual taxpayers, particularly high-income earners and those with income over $400,000 may seek to accelerate their 2020 income to plan for higher tax rates in 2021. This may be accomplished through transactions to realize gains in 2020 and to defer losses and business expenses until 2021. As it pertains to retirement accounts, Roth conversions should be appealing for taxpayers who seek to take advantage of the likelihood of lower tax rates in 2020 than in the future. Additionally, many individuals may want to hold off on making charitable gifts until 2021 to more fully utilize their income tax deduction if income tax rates increase.

Business owners may seek to limit their exposure to higher individual tax rates, and potential increase on social security taxes on wages, through receiving compensation through S-corporation dividends (which are not subject to employment taxes). Alternatively, business owners may seek re-organization or elect to be taxed as a C-Corporation, to reduce their personal exposure to potential increased tax liability.

If the social security tax is expanded, individual executives may also seek to modify their compensation structure and exposure to increased payroll taxes through deferred compensation arrangements, incentive stock options, and non-qualified stock options.

The possibility of long-term capital gains tax rate increasing, from 20% to potentially as high as 39.6%, should motivate individuals to explore selling assets before capital gains rates may significantly increase.

Estate Planning Strategies

Given the possibility of the reduction of the estate exclusion amount from $11.58 million per individual, individuals may seek to make gifts that are currently under the exclusion amount but that that may otherwise be subject to estate tax if the gifts are completed in 2021 or later. Individuals may seek to retain the possible benefits from gifted property, through the execution of various trusts, including spousal lifetime access trusts (SLATs), spousal lifetime access non-grantor trusts (SLANTs), dynasty trusts, domestic asset protection trusts, hybrid domestic asset protection trusts, and special power of appointment trusts.

Furthermore, individuals may seek to reduce exposure to the elimination of "step-up" in basis to recognize gains before death to avoid a potential 39.6% tax rate on capital gains. This may be accomplished through installment sales to non-grantor trusts, charitable trusts, tax-free exchanges, and charitable contributions of appreciated property. Additionally, individuals may seek to utilize tax free transfers of future investment returns through grantor retained annuity trusts (GRATs) and split purchase annuity trusts. The value of these various planning tools is further enhanced by the current low-interest rate environment that is beneficial for some asset transfer strategies. Additionally, depressed asset levels impacted by the pandemic allow for the efficient transfer of assets that may become highly appreciated at a later date.

Given the potential for significant changes in tax policy in 2021, individuals are encouraged to review their current tax situation with their personal tax, financial, and legal advisors before the end of 2020, to determine what steps they may take under current tax laws to reduce their exposure to potential tax increases in the future. Unfortunately, the likely trajectory of tax policy and corresponding changes in tax law will not become clear until after January 5, 2021 when the composition of the U.S. Senate will become known. As a result, individuals should review their individual tax and estate planning at this time, to make informed decisions regarding strategies that may only be available until December 31, 2020.