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Biden Tax Plan

By Bruce Paulson, CPA, JD, CFP®
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The Biden tax plan has been released and is receiving much pre-election commentary. Understanding that planning is difficult until we know the election outcome and the law, however what we know about the tax plan is detailed below. We hope you find the discussion useful, and we welcome any questions.

Tax Law Changes

The proposed tax law changes include:

- Increasing top individual tax rate on income greater than $400,000 to 39.6 percent
- Social Security tax on income greater than $400,000 subject to 12.4 percent supplemental Social Security tax, evenly split between employers and employees
- Dividends and all capital gains when income is greater than $1,000,000 taxed at 39.6 percent
- Tax benefit of itemized deductions capped at 28 percent
- ($10,000 cap on deduction of state and local taxes)—gone
- Like-kind exchanges (1031 rollovers) repealed for income greater than $400,000
- Top corporate income tax rate increases from 21 percent to 28 percent
- Estate taxes
    - Exemption amount - Unclear, but less than the current amount ($11.58 million per person)
    - Rate - No change; remains at 40 percent
    - Removal of income tax-basis step-up—Stated current plan is to tax unrealized asset appreciation at death

Family Wealth Planning Implications

Use of Estate Tax Exemption

Use it or risk losing it. Now is the time to talk to your advisors about making a gift before year-end, which could take different forms (e.g., direct transfer, transfer to a new or existing trust, or forgiveness of an intra-family or entity note receivable). The income tax tradeoffs that come with most gifts are important, especially for taxpayers who are older, hold assets with low-income tax basis, and live in a high tax state, such as Minnesota.

Charitable Remainder Trusts

Taxpayers making over $1,000,000 who receive payments from Charitable Remainder Trusts (CRTs) will pay higher income tax on the portion of their trust payments treated as dividend or long-term capital gain. As advisors know, distributions from a CRT are governed by so-called tier rules that cause trust distributions to consist first of ordinary income, then capital gains, followed by other income, and last, trust corpus. Thus, CRT portfolios are often managed to keep highest taxed income (e.g., ordinary income, short-term capital gains) low compared to lower taxed income (e.g., dividends, long-term capital gains), as highest tax rate income realized always comes out before lower taxed income.

If long-term capital gains (LTCG) are a high percentage of the annual trust distribution, look at creating a separate account equity index (SAEI) solution outside the CRT to systematically harvest tax losses that will eliminate or reduce the tax upon the trust distribution. Perhaps better yet, look at placing the SAEI inside the CRT, where both the duration and benefit from tax loss harvesting could be far higher than if held outside.

Charitable Lead Trusts (CLT)

Charitably minded families who are in top federal or state income tax brackets, face the new 28 percent itemized deduction rate cap, and have assets that generate the highest taxed income may benefit from funding a nongrantor CLT. The trust could be drafted to include income, both realized short and long-term capital gains. This income, while taxable to the trust, should receive an offsetting income tax deduction for amounts paid to charity each year. However, it is important to look into your state's fiduciary laws as they differ in defining what is and is not trust accounting income.

Income—Defective Grantor Trusts

The Biden Administration has not yet targeted the significant, long-term benefit of parents (or grandparents) paying the income tax liabilities on assets residing in trusts that are sheltered from estate tax. If income is taxed at 43 percent or more and the investment still makes pre-tax sense, owning the asset in an income defective grantor trust rises in appeal if the grantor has the cash flow to pay the trust's income tax liabilities.

Grantor Retained Annuity Trusts (GRATs)

There is nothing, to our knowledge, on the table to repeal or impact GRATs, but if the Democrats win the Senate, anything could happen. Families that are thinking of funding a GRAT might consider doing so now to avoid the risk of gift and estate tax laws changing to their detriment. While short-term GRATs are often favored, consideration might be given to funding a longer term GRAT to take advantage of record low interest rates and to eliminate the risk that GRATS could be repealed in coming years.

Installment Sale to Income-Defective Grantor Trust

As with GRATS, there is no proposal that we know of to repeal or impact this type of transaction. Recall, though, that President Obama's budget proposal in 2015 included a provision that (in essence) attacked sales, exchanges, or comparable transactions between a grantor and his or her grantor trust, intending that these assets would be included in the grantor's estate at death or subject to gift tax on certain events during the grantor's life.

Again, families who are considering the installment sale may wish to do so before year end. Higher interest rates in the future pose investment challenges, but they create a potential estate tax opportunity. Remember, the seller holds a fixed rate note receivable, often interest only with a balloon payment at the end. If the seller dies before the note is paid off the fair market value of the note is included in his or her estate. If interest rates have risen from the time of the transaction, both Treasury regulations and case law hold that higher interest rates are one reason to value the note in the estate at an amount less than the outstanding principal balance.

Section 1031 Exchanges

Biden proposes to eliminate like-kind exchanges for investors with annual incomes of more than $400,000. For families who want to reduce real estate exposure and who plan to sell real estate in the next several years, when the LTCG rate may be higher, selling in 2020 may be something to consider.

For families who want to sell real estate and reinvest back into real estate must consider that with a 1031 exchange comes carryover of income tax basis and lower depreciation deductions in future years. If income tax rates rise, depreciation deductions (offsetting rental income) rise in value.

Opportunity zone investments and UPREIT transactions are two other ways to sell real estate and defer or possibly eliminate the income tax liability. Buyer beware: pros and cons exist with each and both involve fee—some not obvious or transparent.

Tax on Unrealized Gains at Death

This proposal raises a whole new can of worms. Most commentators do not feel this proposal will pass and exist side-by-side with an estate tax. With that said, families with grantor trusts that use their trust powers of substitution or acquisition to pull low-income tax basis assets back into their estate may think twice about it. Under the new law, doing so could accelerate income tax on a deferred liability that, if left alone, could be deferred for many years. Instead, trust powers might be used to bring the highest basis assets back into an estate.

Pay Gift Taxes

Families who foresee a higher federal and state taxation of wealth and new laws that trim ways to reduce or shelter wealth from estate tax (e.g., GRATs, note sales, grantor trusts, valuation discounts, etc.) may look more seriously at paying gift tax.

Doing so removes gift tax dollars from exposure to estate taxes, shelters future asset growth from estate tax exposure, and shelters assets from (under Biden proposal) earlier-than-desired payment of income taxes on unrealized capital gains. Grantor trusts would seem natural recipients of large taxable gifts, allowing the grantor to continue paying income taxes for the trust beneficiary. The income tax basis of the gifted asset should receive an upward adjustment for gift taxes paid up to the market value of the asset, but families should check with their tax advisor on this, especially when the asset lands in a grantor trust.

Corporate Stock Redemptions

Private business owners redeeming corporate stock in 2021 may wish to accelerate taxable stock redemptions into 2020. We mention this because whether the corporation is taxed as a C-corporation or S-corporation, distributions taxed as dividends or long-term capital gains face an increase in tax under the Biden administration from 23.8 percent to 43.40 percent.

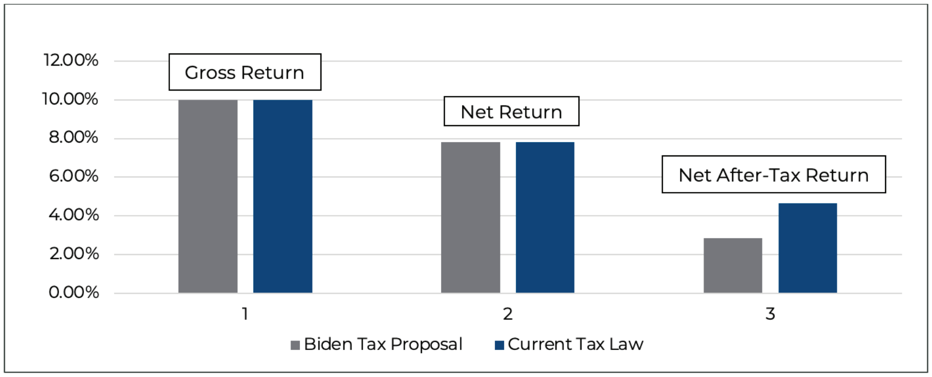
Investment Implications

Hedge Funds

Hedge fund investors with income above $1,000,000 will see their tax on LTCGs rise dramatically from 23.8 percent to 43.4 percent. Most impacted will be funds where the taxable turnover is high and mostly long-term in character. Active investment managers (funds or other) whose tax control efforts rest solely on holding stocks more than 12 months to capture LTCG treatment may need to revisit their stock selection and trading policies to support any claim of being tax efficient.

If we assume 10 percent gross return, 1 percent fee, 15 percent net incentive, .40 percent other costs, and 100 percent taxable turnover and all of it being long term in nature a long-long short manager is impacted even if gains are long term in nature. A taxable turnover number of 100 percent is unrealistic, as is 100 percent of that turnover being long term in nature. Figure One illustrates that keeping gains long term in nature, alone, is no longer enough for an active manager to claim he or she is tax efficient.

Figure One: 100 Percent of LTCG Realized Every 13 months



Source: CAPTRUST Research

Investors should look at the benefits of pairing tax-generating hedge funds with SAEI solutions that harvest tax losses, which offset otherwise taxable long and short-term capital gains.

Active Versus Passive Equity (Net After-Tax)

The oft-vociferous debate continues, as most active managers continue to underperform their respective benchmarks. If dividends and long-term capital gains are taxed at 39.6 percent, most active managers who favor dividend-paying securities and freely realize LTCGs will need to generate a higher pre-tax return to earn their keep when compared to most passive equity solutions, at least where deferral of income tax is measured over a long period of time, such as 10 years.

Separate Account Equity Index (Value of Systematic Tax Loss Harvesting)

For investors with income above $1,000,000, the value of systematic tax loss harvesting from using a separate account equity index portfolio increases in potential value. It could be families who use mutual funds or exchange traded funds (ETF) to capture passive equity exposure would benefit from selling these funds and starting their own separate account equity index portfolio. Whether this makes sense or not will depend upon the following factors.

Families with appreciated assets that might be sold in the near future, actively managed portfolios generating either short- or long-term capital gains, and an upcoming capital gain event (e.g., sale of a business or stock redemption), could well benefit from creating their own, separately managed equity index portfolio to harvest tax losses that, carried forward, would eliminate or reduce tax at 43.40 percent (versus 23.8 percent under current law).

While there are many tax-minimization strategies available, which ones are right for someone and how exactly they should be used is not always clear. With potential for tax code changes in the coming years, it is important for taxpayers to understand how they may be affected and seek out a financial professional who can help them.