PALLAS
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Planning Commentary

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The Winds of Change are Blowin'

SUMMARY

Election years bring with them a chance for major policy changes. Politicians have long used the tax code to "fix" or change the economy, markets, and investor or consumer behavior. This presidential election year will be no different, as President Donald Trump and former Vice President Joe Biden try to convince voters that each is better equipped to lead the nation through the current global health crisis.

Ultimately, regardless of who wins the race, it is important for individuals to be informed about the impact that each candidate's policies will have on their financial planning objectives, and thus to plan accordingly as election results come in!

INTRODUCTION

Do you remember the classic film "Bill and Ted's Excellent Adventure" – from way back in 1989? In one of their adventures through history, we watched those odd characters named Bill and Ted get philosophical with Socrates by telling him, "All we are is dust in the wind, dude."

Well, the winds of change do blow - and sometimes they blow hard. So hard in fact, that you might find yourself saying, "I don't think we're in Kansas anymore." And with 2020 being a U.S. presidential election year – they are blowing once again. In this month's newsletter, we will examine some of the differences between President Trump and former Vice President Biden's tax proposals.

A WORD OF CAUTION

We did not verify these tax policy positions with the candidates themselves, however the information that follows is gathered from numerous sources that are publicly available. Time and space do not permit us to cover all of the very important issues to voters – even when limited to those that fall in the category of tax planning. It is important to note that there are other areas of tax policy for both candidates that are not covered in this short newsletter. For the reader, there are a couple of good online resources that are helpful:

- The Tax Policy Center: **www.taxpolicycenter.org**
- The Tax Foundation: **www.taxfoundation.org**

There are others, but both of the resources above claim to provide analysis that is independent, non-partisan, and updated regularly. I encourage you to peruse those websites, as the information is instructive to each candidate's position on all things tax-related.

TAX PROPOSALS FROM DONALD TRUMP

President Trump's tax policy has not been as detailed as that of his opponent, but he has generally proposed a permanent extension of the individual income and estate tax provisions that were included in the 2017 Tax Cuts and Jobs Act (TCJA). President Trump has proposed a reduction in payroll taxes and seeks to forgive 2020 deferred payroll taxes. His plan includes an expansion of opportunity zones as well as tax incentives for some U.S. businesses to shift certain operations from foreign countries to the U.S.

PROPOSALS IMPACTING:

INDIVIDUAL TAXPAYERS:

- Make permanent the reductions in individual income taxes that were included in the 2017 TCJA.
- Increase childcare tax credits.
- Cut payroll taxes.
- Forgiveness of 2020 payroll tax deferral due.
- Top marginal income tax rate to remain at 37%.
- Tax cut for middle income (22% down to 15%).
- Reducing top cap gains to 15% from 20%.
- Travel credit (Explore America tax credit).
- Allow taxpayers to fully deduct premiums for health insurance purchased in the individual market.
- Extend permanently the estate and gift tax parameters and provisions of the TCJA that would otherwise sunset in 2025.

BUSINESSES AND BUSINESS OWNERS:

- Reduce Corporate (C Corporation) tax rate from 21% to 20%.
- Offer "Made in America" tax credits.
- Establish tax credits for companies that bring jobs back from China.
- Allow businesses in essential industries to deduct 100 percent of certain expenses if they bring their manufacturing back to the United States.
- Expand opportunity zones.
- 100% expensing deductions for essential industries like pharmaceuticals and robotics that bring manufacturing back to the U.S.
- Restoring the deductibility of meals and entertainment costs.
- 100% bonus depreciation permanent.

TAX PROPOSALS FROM JOE BIDEN

Former Vice President Biden would increase income and payroll taxes for high-income individuals (earning over $400,000) and businesses that are structured as C Corporations; expand the child and dependent care tax credit, the earned income tax credit, and the premium tax credit; create a new renter's tax credit; and enhance incentives to save for retirement and purchase homes. Notably, under his plan, federal estate taxes would be increased – sooner than they are already scheduled to increase in 2026 through the "sunset" provisions of the 2017 TCJA. Another significant proposal from Biden is to eliminate the cost basis "step-up" at a decedent's death. Biden's proposals also include numerous incentives for U.S. businesses to conduct operations in the U.S.

PROPOSALS IMPACTING:

INDIVIDUAL TAXPAYERS:

- Repeal the tax cuts from the 2017 TCJA for people with income above $400,000.
- Restore the top individual income tax rate to 39.6%
- Tax capital gains at the same rate as ordinary income (i.e., 39.6%) for taxpayers with over $1 million in income.
- Cap itemized deductions at 28% of value for taxpayers with over $400,000 of income.
- Reinstate the Pease limitation, which was suspended through 2025 under the TCJA, for individuals above the $400,000 in income. By bringing this back, the limitation would reduce itemized deductions by 3% of adjusted gross income in excess of the $400,000 threshold.
- Phase out Qualified Business Income (QBI) deduction for taxpayers with over $400,000 of income.
- Increase the Social Security earnings cap. Biden plans to impose a 12.4% payroll tax on income earned above $400,000, evenly split between employers and employees. This would create a donut hole in the current Social Security payroll tax where wages between $137,700 (the current wage cap), and $400,000 are not taxed. Currently, only $137,700 in wages are subject to this tax, which is 6.2%, and employers are required to pay another 6.2%. (In Biden's plan, those who are self-employed will carry the entire 12.4% themselves.)

BUSINESSES AND BUSINESS OWNERS:

- Increase the top corporate (C Corporation) income tax rate to 28% from 21%.
- Offer tax credits to small businesses to offset the costs of workplace retirement plans.
- Create a tax credit to cover 50% of up to $1 million of a business's costs of constructing a childcare center at a workplace for their employees.
- Impose a 15% minimum tax on companies' book income with credit for taxes paid to other countries.
- Develop a low-carbon manufacturing sector by providing tax credits for businesses to upgrade their equipment and processes, investing in factory construction and expansion, and deploying low-carbon technologies.
- End pharmaceutical companies' tax deduction for advertisement spending.
- Temporarily waive experience rating used for the computation of unemployment insurance taxes when companies use short-time compensation - federal subsidies for businesses that reduce their workers' hours rather than laying off some employees.

TAX PROPOSALS FROM JOE BIDEN (CONTINUED)

PROPOSALS IMPACTING:

INDIVIDUAL TAXPAYERS:

- Eliminate certain tax preferences for real estate investors with over $400,000 of income.
- Increase tax benefits for older Americans who purchase long-term care insurance using their retirement savings.
- Provide various tax credits to incentivize taxpayers to utilize energy efficiently.
- Provide various tax credits to assist renters, child-care and health care workers, and first-time home purchasers.
- Restore the 2009 estate tax levels – Notably 50% reduction in federal estate tax exclusion from $11.58 Million to $5.79 Million.
- Eliminate step up in cost basis at death, and tax capital gains on assets still held by taxpayers when they die.

BUSINESSES AND BUSINESS OWNERS:

- Several incentives to bring business production back to the U.S.:

  1. Impose a 10% surtax on income from the sales of goods produced abroad by a US company and sold in the United States.
  2. Deny deductions and expensing of costs incurred from moving certain jobs or production outside the United States.
  3. Make it more difficult for US multinational corporations to avoid US taxes through certain types of mergers with foreign corporations.
  4. Create a "Made in America" tax credit, payable in advance, for up to 10% of qualifying investments in manufacturing and certain services in the United States; the credit could also apply to incremental increases in payroll for US jobs in manufacturing.
  5. Create new incentives, including tax credits, to encourage domestic production of products designated as critical to national security.

A CLOSER LOOK AT ESTATE TAX CHANGES

Under the current law, married couples can transfer assets of $23.16 million without incurring a federal estate tax. Alternatively, couples can gift this amount without paying any federal gift tax during their lifetimes, and any remaining exclusion can be used to offset estate taxes at death.

- A key feature of the former Vice President Biden's proposed tax plan would be a 50% reduction of the exclusion amount for estate and gift taxes, from $11.58 million ($23.16 million for married couples) to the pre-TCJA amount of $5.79 million.
- Notably, this lapse of the current estate tax exemption amount back to its pre-TCJA limits is already scheduled to occur in 2026 – after the Tax Cuts and Jobs Act sunsets – but the Biden tax plan would accelerate that reversion back to the old limits in 2021 instead.

The current law states that heirs can receive appreciated assets with a step-up in basis to the asset's fair market value at the time of death. Therefore, appreciated assets can be transferred at death without a capital gains tax liability.

- Biden's tax plan proposes to eliminate the step-up in basis rules which would impact both higher- and lower-earners potentially facing a significant and problematic tax bill on inherited assets.

A more structured sale or gifting strategy throughout the owner's lifetime can be a good way to mitigate taxes for the beneficiary should Biden's plan pass. High net worth individuals should consider using as much of their exemption in 2020 as their circumstances allow. Notably, the IRS is already on record stating that it will not "claw back" previous transfers (by gift or by bequest) of assets if the exemption amount goes back to its pre-TCJA levels.

Other strategies that can be considered to deal with a smaller exemption in the long-term can potentially include the use of Grantor Retained Annuity Trusts (GRATs), Charitable Lead Annuity Trusts (CLATs), and sales to Intentionally Defective Grantor Trusts (IDGTs).

Life insurance could see renewed potential as a tool to provide liquidity and/or mitigate the burden of a high tax liability resulting from the inheritance.

CHANGE IS COMING - BUT HOW SOON?

It is difficult to say how soon either candidate's tax proposals become law. However, it is likely that if the Executive branch and the U.S. Senate majority are both from the same political party, changes to tax laws will become a reality in 2021.

With that in mind, in addition to gifting and other estate planning strategies previously discussed, there are several income tax planning strategies that individual taxpayers should consider:

- **Review Roth Conversions:** Roth conversions in 2020 can help defend against the potential for higher taxes for you as well as your heirs. If you wait to do the conversion in 2021, you may be dealing with a higher tax bracket than you are in today.
- **Accelerate Income:** If you expect to earn more than $400,000 per year, you may save significant tax dollars if you can accelerate some of your expected income to 2020. For example, if there are bonuses (over and above the $400,000 in income), it may make sense to have them paid out before 2021 to save on ordinary income taxes and Social Security taxes.
- **Defer Deductions:** If tax rates are expected to increase, the strategy is to push deductions to the following year so that you can offset income that would otherwise be taxed at the higher rate.
- **Accelerate Gains:** With a potential increase in the capital gains tax rate, it may make sense for taxpayers with appreciated assets to consider selling before 2021 to lock in the current tax rates.
- **Defer Unrealized Losses:** If you believe that capital gains rates could be significantly higher after this year, consider taking those losses in future years.
- **Review Business Tax Structure:** For the business owner - once again the decision to be taxed as a C Corporation vs. a pass-through entity (S Corp, Partnership, Sole Proprietor) should be reviewed. Both the immediate and long-term impacts of the decision should be carefully considered.

SUMMARY

In 1789 Benjamin Franklin wrote a letter to a French acquaintance stating that "in this world, nothing is certain except death and taxes…" (That pithy saying may not have been original to him, but we will give him the benefit of the doubt.)

As with any election year, voters have a lot of questions about what changes the future will bring. With apologies to Bob Dylan, the answers are rarely found "blowin' in the wind." However, a careful look at each candidate's tax policy should give individuals and business owners some idea of what lies ahead. The prudent planner will take advantage of windows of opportunity – before the winds of change blow those windows shut… at least for now.

At Pallas, we believe the future is bright for those who plan ahead.

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THE PALLAS PERSPECTIVE

ELECTION SERIES: 2020 ELECTION & TAX IMPLICATIONS

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