PALLAS
CAPITAL ADVISORS

Planning for a Paradigm Shift

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par·a·digm shift
/ˈperəˌdīm SHift/
noun
a fundamental change in approach or underlying assumptions.
-Oxford Languages

Build Back Better – this is the description the Biden Administration has given to the President's three-part economic stimulus plan – comprised of *The American Rescue Plan*, *American Jobs Plan*, and *American Families Plan*. Build Back Better is a projected $7 trillion package of COVID relief, economic stimulus, and infrastructure funding—which encapsulates the Biden administration's vision to address perceived income and wealth inequality and restore the U.S. economy to its pre-pandemic health levels.

On April 28, 2021, President Biden addressed a joint session of Congress during which he introduced the $1.8 billion *American Families Plan*. The proposal, which includes about $1 trillion in investments and $800 billion in middle-class tax credits over a decade, is to be paid for by raising taxes on the wealthiest Americans. While the threshold is not entirely clear at this point – it would seem that those families with over $400,000/year in income will be targeted for much of the tax hike necessary to raise the revenue needed to support the President's plan.

According to whitehouse.gov, this plan consists of three key tenants:

1. ADD AT LEAST FOUR YEARS OF FREE EDUCATION:
- $200 billion for free universal pre-school for all children age three and four years old
- $109 billion for two years of free community college
- $85 billion investment in Pell Grants
- $62 billion to invest in "evidence-based strategies" to strengthen completion and retention rates at community colleges
- $46 billion investment in Historical Black Colleges and Universities, Tribal Colleges and Universities, and other minority-serving institutions.
- $9 billion in teacher training, equipment, and diversity

2. PROVIDE DIRECT SUPPORT TO CHILDREN AND FAMILIES:
- Cover childcare costs for "the most hard-pressed" working families
- Ensure that families earning 1.5 times their state's median income pay no more than seven percent of their income caring for children under age five.
- Childcare providers to receive funding to cover the cost of early childhood care and education
- $15 minimum wage for early childhood staff and kindergarten teachers

- Childcare workers to receive fully-funded training opportunities
- Provide workers up to $4,000/month in paid parental, family, and personal illness/safe leave by year 10 of the program
- Provide workers 3 days of bereavement leave per year
- $25 billion to build on the *American Rescue Plan's* support for Summer Pandemic-EBT to make the program permanent. (The Pandemic Electronic Benefit Transfer (P-EBT) program provides nutritional resources to families who have lost access to free or reduced-price meals due to school or childcare closures.)
- Fund $17 billion to expand free meals for children in the highest poverty districts
- $1 billion for a healthy foods incentive demonstration

3. PROVIDE DIRECT SUPPORT TO CHILDREN AND FAMILIES:

- $200 billion to make *Affordable Care Act* tax credits permanent
- Expand Child Tax Credits and making 17-year-olds eligible, and make the Tax Credit refundable
- Make permanent the temporary Child and Dependent Care Tax Credit expansion that was part of the American Rescue Plan
- Make Earned Income Tax Credit Expansion permanent
- Give IRS oversight of paid tax preparers
- Reform the tax code so "the wealthy have to play by the same rules as everyone else."

That last item on the list is the one that we would like to look at a bit more closely, and it is there where we might discern a fundamentally new way of understanding tax policy. President Biden has said that one of the primary goals of his tax reform is to reward "work not wealth," and thus much of the proposed legislation will change areas of the tax code that have been in place for more than a century. ***As a result, some traditional tax planning will also be turned on its head.***

SO, WHAT IS THE PRESIDENT'S PLAN TO ENSURE THE WEALTHY "PLAY BY THE RULES"?

- Increase investment in the IRS – "ensuring that the additional resources go toward enforcement against those with the highest incomes, rather than Americans with actual income less than $400,000."
- Increase the top tax bracket from 37% to 39.6%.
- Increase the top capital gains and dividend tax rate to 39.7% for those households making over $1 million.
- Eliminate the cost basis "step-up" for deceased taxpayers who have gains in excess of $1 million ($2.5 million per couple when combined with existing real estate exemptions). Under Biden's proposal, these gains will be taxed, regardless of whether the property is sold by the deceased's heirs, unless the property is donated to charity. President Biden is also proposing a limited exception for family businesses and family farms as long as they are owned and operated by the family.
- Hedge Fund partners will no longer be able to take advantage of capital gains tax treatment on carried interests.
- The 3.8% Medicare (*Affordable Care Act*) tax will be applied more "consistently" across the board. Presumably, this means that many more small business owners (e.g., S Corp shareholders) would end up paying the tax.

ELIMINATION OF THE STEP-UP IN BASIS AT DEATH IS A MAJOR TAX POLICY CHANGE

The step-up in basis has been part of the tax code since 1921 and saves taxpayers, including the very wealthy, $40 billion per year in taxes. Traditionally, fundamental estate planning has included "basis management" – that is designing estate plans in such a way that one might plan to include highly appreciated assets in his estate at death – to take advantage of the basis step-up. Thus, heirs could sell the assets with little or no capital gains tax liability. If this aspect of President Biden's proposal is enacted, then the buy-and-hold strategy may become obsolete, and the new strategy would be to strategically sell appreciated positions over time to stay below the $1 million income threshold while alive, and to also avoid big taxable gains that would be due at death.

Perhaps more fundamental is that this change would seem to fly in the face of long-standing principles, namely that the tax code should encourage investment and capital formation, that favorable tax treatment can offset the impact of inflation, and that short-term asset sales should be discouraged. In fact, in some cases, when combined with the 3.8% Affordable Care Act tax, an investor's long-term capital gains tax rate would be higher than the top ordinary income tax bracket.

REDUCTION OF THE FEDERAL ESTATE TAX EXEMPTION STILL A POSSIBILITY?

Notably absent from the White House's Fact Sheet for The American Families Plan is any reference to the federal estate tax exemption. Under previous proposals, the unified gift and estate tax exemption amounts would decrease from $11.7 million to $3.5 million for individuals and $23.4 million to $7 million for married couples. Portability would remain, and those amounts would be indexed to inflation.

It is likely that President Biden and his administration believes that the assessment of a capital gains tax at death would cast a much wider net in terms of capturing revenue. Do recall, however, that absent any new legislation, the sunset of the 2017 Tax Cut and Jobs Act at the end of 2025 will be reducing the lifetime exclusion to $5.49 million (adjusted for inflation) anyway.

CONSIDERATIONS UNDER A NEW PARADIGM

It goes without saying that now more than ever, individuals should seek and rely upon the advice of tax professionals, estate planning attorneys, and their financial planning advisors. Each person's situation will be somewhat unique, however, here are several planning considerations – including some that are time-sensitive:

✓ Consider accelerating income into 2021 and/or ac celerating gains to stay in the lowest capital gains tax bracket.

✓ Reduce taxable income by funding traditional retirement plans, opening profit-sharing, or defined benefit plans.

✓ Consider charitable giving to decrease taxes includ ing Qualified Charitable Distributions (QCDs - if 70½ or over), Charitable Gift Annuities, Charitable Lead/Remainder Trusts Donor Advised Funds, and donating appreciated stock to charity.

✓ If selling a business, consider selling this year, or structuring the transaction as an installment sale that spreads the gain and tax impact over time.

✓ Keep the capital gains tax liability to 23.8% versus potential 43.4% top rate by making sure income stays below $1 million. That may mean accelerating gains into this year (2021).

✓ Future cash flow needs may be met by selling hold ings this year.

✓ Review your balance sheet to determine if you may have $1 million in capital gains at death:

- Consider basis management as an ongoing strategy to bring down taxable gains in portfolios, which may include selling appreciated stock over time to stay within a desired tax bracket (tax-gain harvesting).
- Review irrevocable grantor trusts to determine if they allow for "swapping" assets with other assets owned directly by the grantor. Consider the lack of basis step-up when deciding which assets to hold in irrevocable trusts.

✓ Give attention to annual rebalancing, placing stocks that are anticipated to appreciate into retirement accounts (asset location).

✓ Transfer low basis stocks to lower-income family members (moving up or down).

✓ Review all trusts and estate plans in light of the SECURE Act and potential estate tax changes. Ensure that retirement account distribution provisions written into trusts are in line with the SECURE Act's 10-year distribution rule for non-spouse beneficiaries.

✓ For ultra-high-net-worth families, consider implementing gifting techniques now to drive down the taxable estate, including low-interest notes to children, spousal lifetime access trusts and Grantor Retained Annuity Trusts (GRATs).

Please reach out to the team at Pallas Capital Advisors if you have any questions as it applies to your particular situation.

Sincerely,

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