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Ever Changing Tax Laws

We have all heard the saying that nothing is certain in life except death and taxes. We would argue that never ending changes to our tax code is another certainty. Major changes to the US tax code often take place after elections in which one party replaces the other. We saw this in 2017 when Republicans took control and passed the Tax Cuts and Jobs Act (TCJA). The same thing should be expected if Democrats win both the White House and the Senate in the upcoming election. Regardless of your political persuasion, it is important to be familiar with the current tax code and any changes that may be enacted so you can plan accordingly.

In this newsletter we discuss some of the proposed tax changes that will likely be enacted if the Democrats win both the White House and the Senate. If they only win the White House or the Senate, there will likely be few changes to current tax law.

Executive Summary

- Tax code changes often take place after major elections in which one party replaces the other.
- The Biden tax plan has pledged not to increase taxes on taxpayers earning less than $400,000 a year.
- Capital gain and dividend tax rates would go up on taxable incomes over $1,000,000.
- The Biden tax plan would also eliminate the Qualified Business Income (QBI) tax deduction for business owners whose individual annual income is over $400,000.
- The plan would increase personal income tax credits such as the Childcare Credit, the Child and Dependent Care Tax Credit, the First Time Home Buyer Credit, and a new Care Giver Credit.
- It proposes to eliminate the step-up in cost basis on assets at death.
- The plan also proposes to reduce the exclusion amount for estate and gift taxes by 50% from the current amount of roughly $11.6 million per person to roughly $5.8 million per person.
- It is important to be familiar with the current tax code and any changes that may be enacted so you can plan accordingly.

Possible Income Tax Changes

The Democratic tax proposal - which has become known as the Biden plan - is a pledge not to increase taxes on incomes of less than $400,000. If you fall below this income level, you are not likely to see a tax increase, and actually could see a decrease depending on what types of deductions you have. As you know, state income tax deductions as well as property tax deductions were limited by the 2017 Tax Cuts and Jobs Act (TCJA), and many of these deductions would be reinstated under the Biden plan.

If your taxable income is higher than $400,000, your tax brackets will increase and your deductions will only be deductible at 28% instead of your new higher tax bracket. In a high tax state like California, regaining the ability to write off state income taxes and property taxes on Schedule A could easily offset the higher federal tax brackets and the fact that deductions can only be taken at 28%. See the chart on page 2 for a comparison of current and proposed tax brackets.

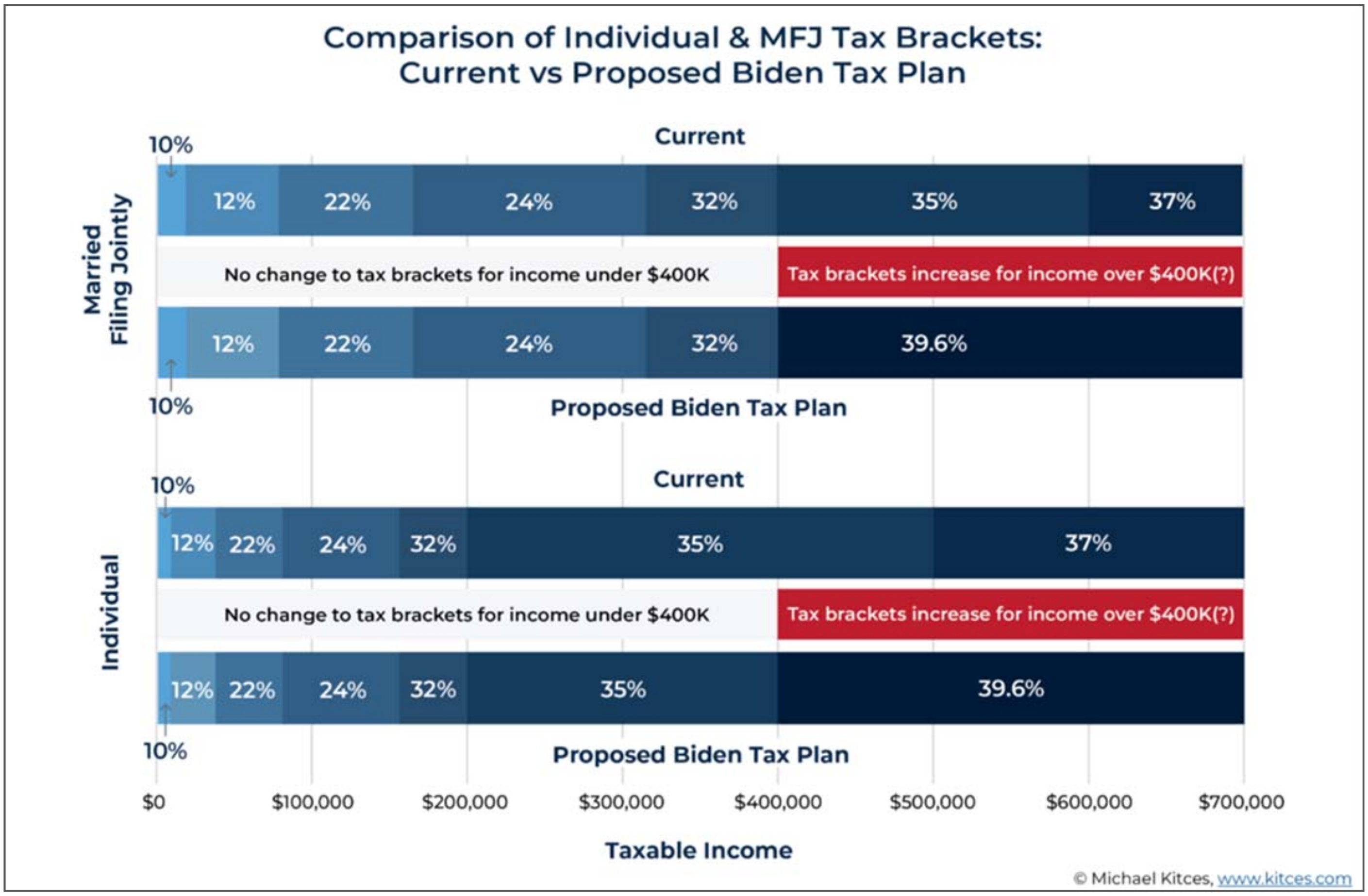
Additional Proposed Changes

The Biden plan would increase personal income tax credits. The old first time Homebuyer Credit would return and provide a credit of up to 10% of the value of the home purchased with a maximum credit of $15,000. A new Caregiver credit of $5,000 for long-term caregivers would be introduced. The current Child and Dependent Care Credit would increase from $3,000 to $8,000 for one child and from $6,000 to $18,000 for two or more children. The current $2,000 Child Tax Credit for children under 17 would become $3,600 for children under 6 and $3,000 for all other children under 17.

The proposed plan would eliminate the Qualified Business Income (QBI) tax deduction for pass through business owners of LLCs, S corporations, partnerships, and sole proprietors. The QBI deduction basically enabled business owner taxpayers to deduct 20% of this income.

The Biden plan is also proposing a Social Security payroll tax on wages above $400,000 with no cap. Social Security payroll taxes for 2020 are only paid on the first $137,700 of wages at a rate of 12.4% (6.2% paid by the employee and 6.2% paid by the employer). This proposal would create a gap where no Social Security tax is owed on wages between $137,700 and $400,000, but then the tax would begin again on wages above $400,000. We already pay a Medicare tax rate of 2.9% (1.45% paid by the employee and 1.45% paid by the employer) on all wages, so under the plan once your wages exceed $400,000 you would pay another 6.2% on top of the current Medicare tax of 1.45%.

An easy way around this tax for successful business owners has been to form an S corporation (or other pass-



through entity), pay a "reasonable salary" (say $100,000) and to take any additional income as an S corporation dividend - which is not subject to payroll taxes. If this new Social Security tax is enacted, this type of tax planning would increase.

A new feature of the Biden plan, that could completely change how high-income earners invest for retirement, is a proposed flat retirement contribution credit that is currently anticipated to be 26%. This would be a net positive for tax paying retirement plan savers who are at or below the 26% bracket, and a net negative for those who are above the 26% bracket.

Currently retirement contributions are deducted from taxable income. So if a wage earner in a 12% tax bracket invested $10,000 into a retirement plan, they would save $1,200 in taxes. Under this new plan they would now get a tax credit of $2,600! This will give them a tremendous incentive to make these contributions.

A high-income wage earner in the 39.6% tax bracket who contributes $10,000 to a retirement program, would reduce their taxes by $3,960 under current law. Under this new plan, they would get a tax credit of only $2,600 and would still have to pay the $1,360 dollar difference, or 13.6%. Not only this, but the money would be taxed again when it is withdrawn. If taxed again at 39.6% when withdrawn, the total tax on this contribution ends up being 53.2%. Plus, this does not even include state taxes – unless states also change their tax codes, this increased taxation would also apply to state income taxes.

If this tax change is enacted, we will be encouraging low tax bracket earners to make retirement contributions and high income earners to alter their retirement savings. This might include making Roth IRA/401(k) contributions, simply paying the tax and investing efficiently in non-retirement accounts, and possibly funding low cost variable annuities. For executives, another avenue for dealing with this would be to participate more aggressively in any deferred compensation plans that may be available to them.

The Biden plan would also subject long-term capital gains and qualified dividend tax rates on incomes over $1 million to ordinary income tax rates. If this happens, more attention will need to be paid to the realization of capital gains taxes. Tax efficient investing and tax loss harvesting will become even more important in this environment. Higher income earners may also want to accelerate some capital gains into 2020 before this change is enacted. And finally, the use of real estate installment sales may make sense to keep income levels below $1 million.

Planning Ideas

Because the Biden plan would subject high income taxpayers to a combination of higher tax rates and a capped benefit for deductions, it could make sense to accelerate both income and deductions into this year. Any income accelerated into 2020 will receive the lower 37% rate and any deductions taken will receive the higher rate deduction. Roth IRA conversions are a simple way to accelerate income, and this will also protect these Roth IRA funds from future higher tax rates. As mentioned, taking additional capital gains before year end is another way to accelerate income into this calendar year. On the deduction side, accelerating planned charitable deductions into 2020 using Charitable trusts or donor advised funds is worth considering. Accelerating business deductions and exercising stock options should also be looked at as well.

For deductions that are capped for some taxpayers, like state income taxes and property tax payments, consider waiting until 2021 if possible – these could become deductible for that year.

Possible Estate Tax Law Changes

The Biden plan proposes to eliminate the step-up in cost basis on assets owned at death. Currently, if you buy a stock at a cost (“cost basis”) of $50,000 and its worth $100,000 when you die, the cost basis of the stock will be updated (stepped-up) to the date of death value of $100,000. If this step-up were eliminated, the inheritor of the stock would retain the original $50,000 cost basis and they would have a $50,000 taxable capital gain if they sell the stock.

There are many questions regarding this provision. Will there be a spousal exception? Will there actually be a capital gains tax due at death vs. “just” a carryover basis? Many are skeptical that this will get passed, and if it does get passed, whether it would remain. Similar changes have been tried in the past and proved unpopular with the public, financial institutions, and the IRS due to complications of tracking the basis and compliance with the proper reporting requirements.

The Biden plan also proposes to reduce the exclusion amount for estate and gift taxes by 50% from the current level of roughly $11.6 million per person to roughly $5.8 million per person. Currently, a married couple can pass roughly $23.2 million, and this would drop to $11.6 million per couple under the Biden plan. This change is already scheduled to take place when the current law “sunsets” at the end of 2025. The Biden plan simply accelerates this time frame.

Planning Ideas

Some high net worth individuals should consider making family gifts to take advantage of the higher current limits before a change is enacted by either the Biden plan, or the end of 2025 when the law sunsets and reverts to the lower limits. This is a complex area and needs to be thoroughly discussed with financial and estate planners on a case by case basis. But suffice it to say that the sooner you begin this discussion the better.

Summary

There is no point in fretting about tax law changes. They will be with us from now until our last days. The important thing to do is to be aware of any potential changes that may affect you and then to come up with a plan to legally minimize your tax liability in the simplest way possible. Some people tie themselves up in knots trying to reduce taxes and end up wishing they had kept things simple and flexible since you never know when current tax law is going to be changed again a few years down the road.

Once we know the results of the election, we will be able to determine what likely tax changes will or will not be enacted. In the meantime, feel free to call us to discuss your own personal situation and how you may be affected and if there is anything you should be planning for. We hope you are staying safe during these unusual times.

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