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President Biden's Budget Includes Big Tax Increases - What You Can Consider for Your Clients Now

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Introduction

On May 28, 2021, the Administration released its Fiscal Year 2022 budget and the Treasury Department released its General Explanation of the Administration's Fiscal Year 2022 Revenue Proposals. Tax advisors, among others, refer to the latter document as the "Green Book". The Administration's proposed a host of tax changes affecting individuals and corporations. Some of the significant proposals that many taxpayers hoped would not be included in the proposed budget, like the tax on transfers at death provision in the Sensible Taxation and Equity Promotion (STEP) Act introduced by Senator Van Hollen and others, are included. Those changes would transform tax and estate planning, raise significant revenues, and might have an impact on the reduction of wealth concentration in America.

Senators Schumer, Sanders and others have reached a deal on a $3.5 trillion Democratic-only infrastructure package. The proposal will, consistent with other proposals and comments that have been made, prohibit tax increases on individuals who make less than $400,000. Senators have also commented that wealthy and large corporations must start paying their fair share of taxes. This might result in some variation of the proposals below being enacted. Practitioners should alert clients that the substantial tax increases and changes that have been talked about since last year could be enacted soon.

Proposed Individual Tax Increases

The Green Book incorporates and further refines proposals made in the American Families Plan, which was announced on April 28, 2021. It would increase income taxation of high-income individuals, restrict tax deferred like-kind exchanges (swaps of real estate that avoid current income taxation that a sale would trigger), and much more. Some of the proposals include:

Higher Tax Rates: The top income tax rates could be bumped up from 37% to 39.6%., effective January 1, 2022. While some had expected that this increase would apply to taxpayers earning over $400,000, the proposal applies to income over $509,300 for married filing joint taxpayers, and to income over $452,700 for single taxpayers. While this is a rate increase, it is not clear from a planning perspective that the 2.6% rate differential alone would justify accelerating income into 2021. But any income acceleration should consider the capital gains rate changes below.

Capital Gains Rates Might Double: Consistent with proposals that have been discussed for a while, long-term capital gains (e.g. sale of stock, investment real estate, etc.) and qualified dividends of those with adjusted gross income over $1 million will be taxed at ordinary income rates of 37%, but only to the extent that the taxpayer's income exceeds the $1 million. That is about double the current 20% rate. This provision would apply to gains triggered after "the date of

announcement", which may be April 28, 2021, the date of announcement of the American Families Plan.

Whether that date turns out to be the actual effective date of the change remains to be seen. If the effective date turns out to be prospective (meaning after 2021) and not retroactive, there could be dramatic and abrupt changes in investment, retirement, and other planning. If a taxpayer were planning on selling investment real estate, a family business, or diversifying out of a concentrated stock position or doing a life settlement with a very large policy, it might be beneficial to sell now before the rates double! The assessment could include forecasts reflecting various tax and economic scenarios to determine what might be worth pursuing. But be careful, as so much depends on the effective date of any such change. If this change is enacted, future planning, meaning beyond 2021, could be dramatically changed. Taxpayers might forecast and plan sales and income for a decade or longer into the future. Then, actions can be taken to control income realization to stay below the $1 million threshold and avoid the approximately doubled rates. This might include using installment sale treatment, charitable remainder trusts and more. Harvesting gains and losses may take on a very different approach than it has had historically.

Social Security Taxes: Another proposal is to coordinate the net investment income and self-employment taxes. Historically, high income taxpayers who earned income from a closely held business, e.g. a physician from her medical practice, paid themselves a more modest salary that was subject to Social Security taxes. The remaining profits were withdrawn as a distribution to owners that was not subject to those taxes, e.g. S corporation distributions. The savings, especially over years of work, could be substantial.

The proposal is that all passthrough business income (e.g. S corporations, limited liability companies, partnerships) of high-income taxpayers will be subject to either the net investment income tax or Social Security taxes. That might result in the restructure of closely held business entities, revisions to governing documents (e.g. partnership agreements) and changes in how profits, salary and other payments are made. This may have ripple effects on valuations, buy-out agreements, and more.

Carried Interests: Hedge fund principals may face higher taxes as carried interests will be taxed as ordinary income instead of capital gains, about a doubling of the rates.

More Audits: The administration has placed a major focus on enforcement. In fact, the American Families Plan proposes an $80 billion increase over the next ten years in the budget for IRS enforcement and compliance. The proposal would direct these additional resources be used only for enforcement on high earners and large corporations. Individuals earning over $400,000 would face a higher likelihood of a tax audit.

Estate and gift tax provisions

The Biden administration has, so far at least, not proposed changes to the estate and gift tax exemptions or rates, GRATs, etc. Of course, that may change, but perhaps for now the administration may be content to let the current exemption amount sunset in 2026 and focus its efforts on deemed realization which they may view as having a more substantial impact on

wealth concentration. That said, the proposals that the Biden administration has put forth can fairly be described as "transformative". Senator Sanders' proposal, "For the 99.5% Act" does call for a return to lower exemptions as well as significant changes to the rules on GRATs and grantor trusts, among other things. It is possible that, ultimately, some (or all) of Senator Sanders' proposal could be enacted along with a deemed realization system.

New Realization Tax on Transfers: Perhaps the most dramatic change under the Biden proposal, is to make the transfer of property by gift and on assets owned at death as of January 1, 2022 trigger events for capital gains tax. The proposal would assume that the donor or deceased literally sold the asset on the date of gift or death. Of course, there is no actual buyer and no sales proceeds! The gain would be measured by the excess of the fair market value of the asset at the date the gift is made or the date of the decedent's death dies over that person's basis in the asset.

Fortunately, there are notable exclusions, meaning transfers that would not trigger gain. For example, a transfer at death to a (U.S.) spouse would not trigger gain. Query whether the definition of "transfer to a spouse" has implications for traditional "A/B" trust planning. There is no mention of a transfer by gift to a spouse. Commentators assume that that omission was just an oversight. In any event, the spouse would take a carryover basis and gain would be triggered when he or she gives away the asset or dies owning it. More on this later.

A transfer to charity would not trigger gain, though a transfer to a charitable remainder or lead trust could apparently trigger gain attributable to the non-charitable portion. These split-interest trusts are mainstays of income, gift and estate tax planning and they are often funded with appreciated property. Depending on the design of the trust and the size of the remainder or lead interest, that type of funding could trigger substantial capital gain. Taxpayers who are currently considering these trusts will want to monitor developments with this proposal to determine if they should proceed in 2021. Taxpayers should also consider the risk of a Van Hollen proposal with a retroactive date being enacted.

A transfer to a trust would not trigger gain if the trust were a grantor trust, revocable by the grantor. When the grantor dies or the trust is no longer revocable, the gain would be triggered. Transfers by gift to irrevocable trusts that are not includible in the grantor's estate would trigger gain. Planners structure sales to defective grantor trusts for full and adequate consideration to avoid a gift element (other than the seed cash, presumably). Even if these transactions still work under a new deemed realization system, there will be increased downside risk to a successfully contested valuation, for example. This suggests the continuing importance on proper valuation and, no doubt, the use of formula clauses to prevent transactions from containing a gift element. Beyond these transactions, the full implications of gifts of appreciated property to irrevocable trusts triggering gain would come into play in many forms of planning.

Fortunately, there is an exclusion for transfers of $1 million of gain, indexed for inflation after 2022. That exclusion would be portable between spouses so that as a unit, they would have $2 million in exclusion. The fact that the exclusion is portable suggests that "traditional" portability planning will have to be expanded to address this new rule. There is also a $250,000 exclusion ($500,00 for couples) for gain in a personal residence. The proposal addresses the basis that a recipient of a gift or devise would take in the transferred asset, but further clarification is needed.

(The “gain” at death of a life insurance policy - that is the death benefit in excess of basis - is not subject to that tax.)

If the asset transferred by gift or bequeathed at death is an interest in a family-owned and operated business, an undefined term, the tax would not have to be paid until the business is sold or is no longer family-owned and operated. Clearly, this proposal adds a new dimension to business owners’ liquidity planning.

The imposition of the capital gains tax on non-excluded transfers adds a new dimension of taxation to gifts. The realization of gain at death, again measured by the difference between fair market value a death and the deceased’s cost basis in the asset, is a major departure from current law, which provides for a stepped-up basis at death and no triggering of gain. These are transformative changes.

Tax on Trusts and Entities: There is another facet to the above realization regime. Gain on unrealized appreciation also would be recognized by a trust, partnership, or other non- corporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years, with such testing period beginning on January 1, 1940. The first possible recognition event for any taxpayer under this provision would thus be December 31, 2030. This might suggest that an individual who created irrevocable trusts (or creates them now to try to avoid a reduction in exemption, which might not be incorporated into new legislation) a capital gains tax could be due on all appreciation as soon as 2030! What planning options might exist? Might trustees be able to distribute appreciated assets to beneficiaries to avoid that tax? Will trust agreements permit that? Will lots of grandchildren be receiving distributions before that date?

Business Tax Increases

The American Jobs Plan proposes several corporate tax changes including the increase corporate income tax rate to 28% from its current 21%. For those who restructured family and closely held business entities to regular or “C” corporation form to take advantage of lower corporate tax rates, this change might have them evaluate switching to an S corporation or other format. That, however, is not so simple as there can be costs in restructuring C corporations. Moving forward, the decision as to which type of business structure and choice of entity may change from what it has been since the 2017 tax law changes. Careful review of estate planning documents, especially trusts, will be needed. Changing a C corporation to an S corporation owned by irrevocable trusts will require special provisions to avoid tainting the tax favored status of an S corporation (the pass through of income to owners instead of paying a corporate tax). A great deal of analysis will be required, not just on the income tax side, but also on the estate and gift tax side to the extent that passthrough status was a key element of a wealth transfer technique.

What do clients need to know (or do) now?

It may take time for the various proposals on realization of gain on transfers to coalesce into legislation, if it ever does. On the other hand, it is possible that the Democrats push through an infrastructure or spending bill inclusive of tax legislation. There are just so many nuances to the proposal, apparent oversights and points that need further definition and clarification, both as to

the law itself and the associated compliance procedures. So it's understandable that individuals might defer consideration of planning responses to the proposals until they have a much better idea of whether and how those proposals would affect them personally, in real time. But that may be too late.

Nuance and lack of clarity aside, however, there is no question that these proposals could seriously undermine the foundation of many high income, high net worth individuals 'tax, investment, estate and business succession plans. Therefore, individuals whose income and base of appreciated capital assets clearly indicate that the proposals would have significant impact on their tax and liquidity planning might ask their estate, tax, investment and insurance advisors to collaborate on an overview assessment of how things would play out if the key elements of the proposals were to become law.

Based on that assessment, client conversations could run the gamut of fact patterns and timing issues. For example, an individual who wants to make gifts of appreciated assets to use some of the current $11.7 million transfer tax exemption just in case that is reduced in the future needs to evaluate when those transfers might trigger capital gains tax if made after the effective date of the new legislation. And remember with the Van Hollen proposal that is January 1, 2021. So, immediate action might be worthwhile. But that individual's advisors might suggest techniques to unwind the transfers to avoid an unintended capital gains tax if triggered. Some advisors integrate provisions into irrevocable trusts that are a common recipient of gift transfers that permit one or more persons (trustee, one primary beneficiary, or all beneficiaries) to disclaim the transfers thereby (hopefully!) unwinding the transfers. For income tax purposes it may be possible to rescind a transaction during the same tax year if it trips over the effective date. Another approach may be to borrow money and gift the borrowed cash rather than appreciated assets.

Consider what this type of change might do to future planning? If an individual's estate will pay capital gains on all appreciation in assets he or she owned on death, the historic bias of holding assets until death so that the capital gains would disappear because of the step-up may prove costly. Instead, a totally new planning approach may become the rage. Individuals' tax and investment advisors can collaborate on projections that forecast the income and tax consequences of various approaches to timing sales for years or even decades. It might prove advantageous for some to realize some amount of gain each year before death to avoid the higher almost 40% tax on death. Advisors might suggest some adjustments to portfolios and how the investments are held. Of course, estate planning documents might benefit from amendments to permit this type of planning.

Private Placement Life Insurance

Another possible option may be in the form of a popular planning strategy often used today to minimize a client's exposure to high income and capital gains taxes, Private Placement Life Insurance (PPLI). Moving forward, PPLI could be reviewed as a potential solution to minimize the burden of a proposed or enacted increase in income and capital gains taxes. Today, PPLI policies can be structured very cost effectively. The cost of these PPLI insurance wrappers generally average 100 basis points or 1% annually. This is a low price to pay in order to possibly avoid federal and state income and capital gains taxes. These modern PPLI policies allow for a wide variety of investment opportunities. They can frequently be designed around investments of

the client's choice. A PPLI policy owned by a trust providing a wrapper around trust investments may result in a zero-tax trust. Generally, if a trust owns a PPLI policy it will be sitused in one of the modern trust states with low state premium taxes such as Alaska, Delaware, South Dakota and Wyoming. The premium tax savings can average 200 basis points (i.e., 2%) or more. (Non-PPLI policies, those available commercially, will take out the 2.00% or more, regardless of the state in which the policy was purchased.)

Because you can only purchase life insurance with cash, the individual with a portfolio with built in gain will have to sell that portfolio, realize the gain, pay the taxes (albeit at a lower rate) before putting the money into a PPLI policy. If someone has an individual manager running the money it is highly possible they can continue to have that manager invest the money in the PPLI. To potentially avoid the 90-year rule a trust could own PPLI. When the insured dies they can take the proceeds and put them into a new PPLI policy and continue the strategy. As long as a policy is not a Modified Endowment Contract (MEC) money can be accessed by loans that will not be subject to income taxes. This is a way distributions can be made, as long as the insured dies with the policy still in force. Policies can usually satisfy the MEC rule by having premiums put in over four years.

Additional Considerations

There are many other planning implications worthy of at least some discussion now. Maybe a high priority would be to revisit the tax and economic implications of the way a company's buy-sell agreement is structured and funded. And it's not just the buy-sell. This change could call for a major recalibration of a business owner's liquidity needs! Maybe an intended outright bequest of appreciated property to a friend or relative should be recast with a charitable component to avoid realization of gain on death, though the use of a charitable remainder or lead trust to pass wealth at death might have to be put on the watch list. Maybe that long-deferred medical exam for life insurance should be done sooner rather than later in light of either the potential need for more liquidity due to realization or for income tax deferral purposes. Of course, any recommended adjustments would have the burden of proof that they wouldn't be counterproductive and regrettable if those proposals never do coalesce into a new set of rules.

To be sure, there is tension between waiting for clarity of the when and what of potential legislation and waiting so long that is impossible to get things in place before a new law is effective. Unfortunately, the effective date of tax legislation is often a date certain, like January 1st, not January 1st or as soon thereafter as the individual is ready. The point is that, in fairness, this time is different enough and the potential changes draconian enough, that individuals should plan on giving themselves and their advisors enough lead time to make informed decisions and implement sound plans in a timely fashion.

Non-Tax Considerations

Nevertheless, while taxes are certainly important, the key non-tax benefits to trusts in inter-generational estate planning will continue to be critical. Modern trust laws found in boutique trust jurisdictions such as Alaska, Delaware, Nevada, New Hampshire, South Dakota, Tennessee, and Wyoming will continue to play an important role in a client's overall legacy planning. In fact, today many families view the non-tax benefits of modern trust laws as important or even more

important than the tax benefits. These non-tax benefits include privacy, asset protection, and the promotion of family values. As such, no matter what tax legislation is enacted, client's will continue to be concerned with keeping their trusts 'quiet' from beneficiaries with potential problems, they will continue to care about protecting their children from troubled ex-spouses and they will continue to desire investment and distribution flexibility. Many of these planning goals are achieved today and should continue moving forward. Consequently, trusts should continue to be drafted with modern trust concepts in long-term or perpetual trust states with statutes providing for directed trusts, asset protection, privacy, decanting, reformation/modification, virtual representation etc. to deal with future uncertainty. In addition, existing trusts should be reviewed and be reformed and decanted to do the same, if they have not already been drafted to do such.

Conclusion

Regardless of what finally results, these are things you need to consider and reach out to clients with now because time is of the essence.

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