Advanced Planning Perspectives

Legislative Process and Timing

The results of the 2020 elections have increased the likelihood of tax increases on high-income earners and the wealthy. With the Senate split evenly between Democrats and Republicans, the deciding tiebreaking vote would be cast by the vice president, Kamala Harris, in a deadlock situation. The tiebreaking vote gives Democrats the potential to advance their key priorities (e.g., a stimulus package and policies addressing climate change, racial equity and civil rights).

It is highly anticipated that tax increases will be enacted under President Biden's administration, despite the narrow margin of victory for the Democrats. There are three options for advancing such legislation:

- Engaging in bipartisan cooperation with Republicans to achieve the 60-vote threshold.
- Changing the filibuster rules. The filibuster is a procedural mechanism that permits the minority party to block legislation from advancing in the Senate by keeping the debate open on a legislative item until the Senate votes to close it. Closing the debate requires 60 votes. If the majority party falls short of the 60 votes, the legislation stalls and does not move to final voting. The hurdle to eliminating the filibuster is that not all Democrats are in favor of abolishing it. In particular, centrist Democratic Senators Joe Manchin III of West Virginia and Kyrsten Sinema of Arizona are opposed to its elimination.
- Using the reconciliation process to make legislation easier to pass in the Senate. Ordinarily, 60 votes are needed to pass legislation; in contrast, a reconciliation bill only needs a simple majority of 51 votes. Reconciliation bills, however, must be narrow in scope — only policies that change spending or revenue can be included. Also, only one reconciliation bill may be passed per legislative cycle. Congress did not pass a budget resolution for the current fiscal year; therefore, Congress will have two fiscal years' budgets available to it. The next reconciliation package, for the next fiscal year, may include tax changes.

While the Biden administration has set forth a proposed tax plan in broad strokes, many of the details have not been explained. Below are a few insights into the administration's proposal.

Individual Income Taxes

Ordinary Income Tax Rate

Biden's tax plan is progressive, generally increasing taxes on high-income earners. The proposal increases the highest marginal income tax rate from 37% to 39.6%. Additionally, it is likely that the tax brackets would change so that the highest marginal rate would apply at a lower income level. According to the proposal, this change will impact taxpayers with income in excess of $400,000. However, there has been no indication if the $400,000 threshold would apply to single, head of household and/or joint tax filers.

Long-Term Gains / Qualified Dividends

Under current law, long-term capital gains and qualified dividends receive favorable tax treatment. Currently, the tax rate on long-term capital gains and qualified dividends is 20% for the highest earners, and either 15% or 0% for all others, depending on income level. There is an additional net investment income tax imposed at a rate of 3.8% on certain investment income, depending on the taxpayer's filing status, total investment income and annual income. Under Biden's tax proposal, taxpayers with annual income exceeding $1 million would be taxed at the highest ordinary income tax rate of 39.6% on long-term capital gains and qualified dividends. It is not clear whether the net investment income tax would continue to apply or to what extent.

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1031 "Like-Kind" Exchanges

Section 1031 of the tax code permits real estate investors to defer recognition of capital gain indefinitely on the sale of investment real estate if the sale proceeds are reinvested in another investment property within a specified period. Prior to 2018, the tax code permitted like-kind exchanges to defer the recognition of capital gain on the sale of many types of investment assets, not just real estate. However, the Tax Cuts and Jobs Act, enacted in 2017, limited like-kind exchanges to only investment real estate. Under Biden's proposed tax plan, 1031 like-kind exchanges of real estate would be repealed. That change could impose significant financial challenges for real estate investors.

Income Tax Deductions

Cap on Itemized Deductions / Reinstatement of Pease Limitation

Currently, an overall cap on itemized deductions does not apply (but there are dollar limits on specific itemized deductions, such as the mortgage interest deduction and state and local tax [SALT] deduction). Accordingly, for the highest earners, itemized deductions may be worth up to 37% of their total dollar amount in 2021. For example, for a family in the highest tax bracket, $100,000 of itemized deductions could be worth up to $37,000. Biden's tax plan proposes capping itemized deductions at a 28% rate for all taxpayers, which means that the same $100,000 of itemized deductions would be worth a maximum of $28,000 if the proposal becomes law. A percentage cap on itemized deductions indirectly increases taxes on higher incomes.

To further limit itemized deductions, Biden also proposes reinstating the Pease limitation on itemized deductions (currently suspended for tax years 2018 through 2025 by the Tax Cuts and Jobs Act). The Pease limitation required high-income taxpayers to reduce the value of certain itemized deductions, including mortgage interest, SALT and charitable contribution deductions. Essentially, the Pease limitation required taxpayers with adjusted gross income (AGI) above a certain threshold to reduce the applicable itemized deductions by the lesser of (1) 3% of the difference between the taxpayer's AGI and the AGI threshold and (2) 80% of the applicable itemized deductions. Reinstatement of the Pease limitation together with an overall cap on itemized deductions could have a significant impact on high-income taxpayers.

Phaseout of the Qualified Business Income (QBI) Deduction

Currently, under Internal Revenue Code Section 199A, owners of certain businesses operating as pass-through entities — such as sole proprietorships, partnerships, limited liability companies and S corporations — may deduct up to 20% of QBI. The QBI deduction is subject to many limitations, but for some business owners, it may result in tax savings on business income. Biden's tax proposal phases out the QBI tax deduction for taxpayers earning more than $400,000.

Elimination of the Cap on SALT Deduction

Prior to 2018, the SALT deduction was subject only to general limitations on itemized deductions. However, under current law, the SALT deduction is limited to a dollar amount of $10,000. Biden's tax plan proposes eliminating the $10,000 cap on the SALT deduction, but it is possible (as noted above) that all itemized deductions, including the SALT deduction, would be subject to a 28% cap. The SALT deduction also could be subject to the Pease limitation under Biden's tax proposal. Accordingly, the benefit of the SALT deduction could be limited even if not subject to a $10,000 annual dollar cap.

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Payroll Taxes

Federal payroll taxes are evenly split between employers and employees (with the self-employed paying 100%). The combined Social Security and Medicare tax rate is 15.3%. The employee portion of the payroll tax is 7.65% of wages, of which 6.2% applies to Social Security and 1.45% applies to Medicare. The employer portion of the tax is also 7.65% of wages, with the same percentages going to Social Security and Medicare. However, a salary cap currently applies to both the employer and employee portions of the Social Security payroll tax. The salary cap for the Social Security payroll tax, which increases annually, is $142,800 in 2021 (up from $137,700 last year). There is no salary cap on the Medicare portion of the tax. High-income earners are also subject to an additional 0.9% Medicare payroll tax on income above a certain threshold (generally $200,000 for single and $250,000 for joint filers).

Biden's proposal would continue the current payroll tax and include an additional payroll tax of 12.4% (the employer and the employee each pay half) on earned income of $400,000 or more. This change would essentially mean that income below $142,800 and above $400,000 would be subject to a Social Security payroll tax of 12.4%, with payment evenly split by the employer and employee.

Corporate Taxes

The income tax rate on C corporation earnings would likely increase if Biden's tax plan is enacted. The current federal corporate tax rate is 21%. Biden's tax plan proposes increasing the tax rate on corporate earnings to 28% (still lower than the 35% rate in effect before the Tax Cuts and Jobs Act). The plan also proposes a 15% minimum tax on "book" profits for corporations with at least $100 million of annual income but would still allow for net operating losses and foreign tax credits.

Estate, Gift and Generation-Skipping Transfer (GST) Taxes

One consistent policy agenda of Democrats has been to target the transfer of intergenerational wealth. Various proposals to accomplish this goal have been floated in recent years, including lower estate, gift and GST tax exemptions; higher tax rates; elimination of the step-up in cost basis at death; and even a wealth tax. Under current law, the federal estate, gift and GST tax exemption amounts are $11.7 million per person in 2021, and the top tax rate is 40%. Even if no changes are made, the exemption amount is scheduled to revert to the prior level of $5 million (indexed for inflation) at the end of 2025. Below is a list of estate, gift and GST tax changes that could be included in Biden's proposed tax legislation:

- Lower estate, gift and GST tax exemption amounts
- Higher estate, gift and GST tax rates
- Elimination of cost basis step-up at death
- Elimination of valuation discounts for closely held entities
- Limitations on grantor retained annuity trusts (GRATs)
- Limitations on use of intentionally defective grantor trusts (IDGTs)

Notably, a wealth tax is absent from the list, but there have been recent discussions in Congress about such a tax.

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Conclusion

Even though there is much uncertainty about the future of federal tax law (i.e., what the income and transfer taxes will be and when such changes will be made effective), it is highly likely that taxes will increase. One thing is certain: This is a critical time to think about your financial well-being. Now is the time to review your financial goals and legacy with your financial advisors to plan for the anticipated changes. Accordingly, there are planning strategies you may wish to discuss with your financial and tax advisors, including:

- Consider converting a traditional IRA to a Roth IRA while ordinary income tax rates are lower than they are likely to be in the future.
- If you plan to recognize significant long-term capital gains in the near future and have control over the timing, consider accelerating those gains to take advantage of a possibly lower capital gains tax rate now.
- Review and realign your overall asset allocation during a portfolio review with your wealth manager.
- Consider taking advantage of the large transfer tax exemptions now, and identify appropriate assets that may be gifted.
- Consider strategies to utilize your gift tax exemption in a way that provides flexibility in the event the exemption changes or remains the same. Such strategies include utilizing irrevocable trusts and promissory notes and the flexibility to forgive the promissory notes.
- Consider establishing a family partnership or an LLC and using it as a vehicle to make discounted gifts to trusts for family members.
- Consider deferring itemized deductions (e.g., SALT and charitable) to the later part of this year or 2022, when there is more clarity around legislative tax changes for 2021. Certain deductions may be more valuable after the proposed tax law changes.

Meet with your advisors to discuss what may be the right path for you. Your First Republic team is here to help.

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