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FOR WHAT IT'S WORTH

Proactive Tax Management in an Election Year

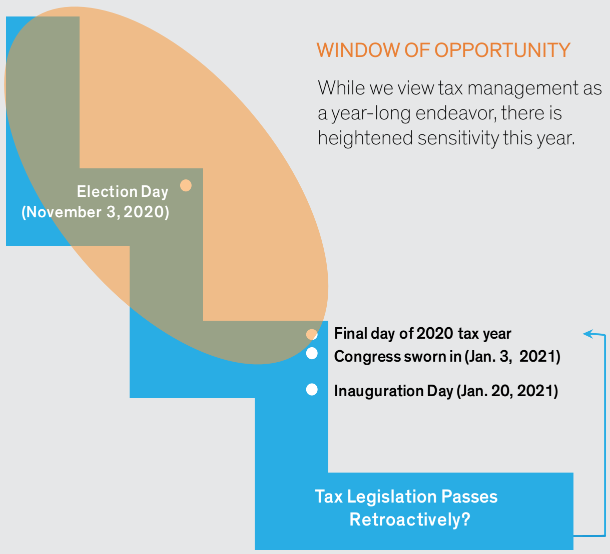
As we pointed out in our recent blog series, elections have consequences—on markets, the economy, and portfolio positioning. But beyond these aspects of wealth, many of our clients are focused on individual tax issues. After all, when it comes to returns, it's not what you make, but what you keep after taxes, that matters. For individuals, two types of taxes loom largest: income taxes (including capital gains) and transfer taxes (gift and estate).

We'll explore each in turn; but before tackling the specifics, it's important to keep the following in mind:

- Not all tax law changes come in the form of standalone legislation. For example, the 3.8% surtax on net investment income was part of the Affordable Care Act. And the SECURE Act—legislation broadly aimed at helping Americans save for retirement—ushered in recent changes impacting the withdrawal of tax-deferred income by inherited IRA beneficiaries.[1] Seemingly minor tweaks to the structure of the income or estate tax system may have an outsized impact on a given client's plan.
- The precedent for retroactive tax legislation already exists[2] (see sidebar "How a Bill Becomes a Law" on p. 4). This means that the window of opportunity to plan may be narrow, depending on the outcome of the election. Planning may need to be completed prior to December 31, 2020 (**Display 1**).

DISPLAY 1: WHEN WILL WE HAVE TO MAKE TAX MANAGEMENT DECISIONS?

Tax Policy Changes May Be Retroactive to January 2021



Source: AB analytics

[1] Generally, the SECURE Act (Pub. L. No. 116-94) requires retirement plans to be completely distributed to designated beneficiaries by December 31 of the year containing the 10th anniversary of the participant's death unless an exception applies.

[2] The Supreme Court has recognized that retroactive application of tax laws is a "customary congressional practice" sometimes required by "the practicalities of producing national legislation." In United States v. Carlton, the Supreme Court held that the retroactive application of an amendment to the Tax Reform Act of 1986 met the requirements of due process despite a taxpayer's reliance on the original code and noted that "tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code." In 1999, the Ninth Circuit Court of Appeals ruled in Quarty v. U.S. that a retroactive tax increase does not violate the Constitution. The court held that the increase in the estate and gift tax rates was a rational means to raise revenue, noting that an increase in tax rate was merely an increase of an existing tax, not a wholly new tax, citing other court decisions as precedent.

COMPARING INCOME TAX PROPOSALS

How might the future tax landscape take shape? A Republican sweep would likely leave tax rates intact and may look to extend some parts of the 2017 Tax Cuts and Jobs Act (TCJA) that are scheduled to sunset after 2025. Additionally, President Trump has suggested reducing capital gains taxes by either cutting the tax rate or indexing cost basis to inflation.

On the other hand, former Vice President Joe Biden's tax increases would mainly target high-income earners. Specifically, the Democratic nominee proposes immediately restoring income tax rates to the pre-TCJA levels for taxpayers with income above $400,000. In contrast, many itemized deductions—including those for state and local income taxes—would return, but so would limitations on their use by taxpayers with income above $400,000.

In addition, Biden would tax capital gains and dividends (and potentially carried interest) at the same rate as ordinary income for those with income above $1 million. This would effectively double the tax rate on long-term capital gains for assets held in excess of one year from 20.0% to 39.6% for taxpayers with adjusted gross income (AGI) exceeding $1 million. Finally, Biden would roll back tax-free exchanges under Section 1031 for real estate investors with incomes over $400,000.

COMPARING ESTATE TAX PROPOSALS

What about the backdrop for estate planning? Again, Republican policy aims to maintain and extend the status quo. We could see a push for making the expanded estate tax exclusion under the TCJA permanent.

In contrast to other Democrats, Joe Biden does not espouse a whole new wealth tax, but instead suggests "returning the estate tax to 2009 levels."[3] Presumably, this would mean a $3.5 million applicable exclusion versus the current $11.58 million applicable exclusion—a 70% reduction.[4] In addition, Biden has proposed eliminating the "step-up" in basis under I.R.C. Section 1014 and taxing capital gains at death (**see sidebar**).

Finally, Biden has proposed closing loopholes broadly. In the absence of specifics, we can surmise the likeliest targets based on similar proposals made by the Obama administration. In 2016, the Obama administration recommended the following:

- requiring a minimum 10-year term for grantor retained annuity trusts (GRATs)
- requiring GRATs to have a minimum remainder interest of the greater of (i) 25% of the assets contributed to the GRAT or (ii) $500,000 (but not more than the value of the assets contributed)
- prohibition against grantors engaging in tax-free exchanges
- requiring any property transferred to a grantor trust by sale or exchange (including future appreciation and distributions) to be includable in the grantor's estate for estate and gift tax purposes, and a $50,000 per donor cap on annual exclusion gifts[5]

LOSING A STEP-UP?

Instead of an estate or inheritance tax, Canada treats estates as if all the decedent's assets had been sold at death and imposes a capital gains tax, unless the spouse or common-law partner of the deceased inherits the estate. Mirroring such an approach in the US goes beyond mere speculation; an early draft of President Trump's 2016 tax reform proposal included a similar provision for a forced recognition of capital gains at death for estates greater than $10 million.

The prospect of taxing unrealized capital gains at death was also put forward by the Obama administration in 2016. The plan contemplated an exemption for transfers to spouses and charity, a $100,000 per-person exclusion along with one for tangible personal property, and the ability to deduct the capital gains tax against estate taxes.[6]

Such a provision would represent a major departure from past practice. One nearly consistent feature of our estate tax system has been a basis adjustment to fair market value commonly known as the "step-up" in cost basis on assets in the decedent's estate at death.[7] This step-up eliminates embedded capital gains on a decedent's balance sheet so that heirs can freely sell inherited property without incurring additional capital gains tax.

Loss of the step-up could create significant difficulties for anyone who inherits a highly appreciated asset but may result in more efficient allocation of capital throughout the economy. And in the short run, it would increase revenue. After all, why would families continue to hold an unwanted asset absent the promise of a future step-up in cost basis? Eliminating the step-up would certainly change conventional thinking on estate planning with highly appreciated assets.

[3] "Highlights of Joe Biden's Plans to Support Women during the COVID-19 Crisis," https://joebiden.com/plans-to-support-women-duringcovid19/.

[4] The estate tax exclusion in 2009 was $3.5 million, but the lifetime gift tax exclusion was only $1 million. In addition, the estate tax rate was 45%, which was higher than today's rate of 40%.

[5] "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals," Department of the Treasury, February 2016, https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf (pages 180–182).

[6] Ibid.

[7] Under IRC Section 1014, cost basis is either "stepped up" to eliminate a gain or "stepped down" to eliminate a loss.

Many of these proposals emerged prior to the pandemic—and the trillions of dollars in deficit spending to keep the economy afloat. While fiscal spending puts upward pressure on future taxes, the fragility of the US economic system amid an ongoing pandemic may delay the speed at which any income tax increases take effect.

On the other hand, increases in transfer taxes—whether directly via the transfer tax rate, lowering of the applicable exclusion, eliminating the step-up in basis at death, or other avenues for raising revenue like eliminating zeroed-out GRATs—face no practical economic barrier. For that reason, wealth transfer taxes could serve as a more immediate target than corporate or individual income tax rates, even though they wouldn't raise as much revenue.

A BLUEPRINT FOR ACTION

Given the extraordinary uncertainty, what should investors do now? Unfortunately, there's no one-size-fits-all response. Much depends on the goals you are trying to achieve and plans already in place. Bernstein can help you walk through the questions below to determine potential next steps.

DEFINE YOUR POSITION

- Before contemplating which steps you should take, assess your current circumstances. What assets do you have and how are they held? What is their cost basis?
- Do you have the right team in place to help you plan? If not, make it a priority to engage a new estate planner or accountant now.

EVALUATE POTENTIAL MOVES

- Does your portfolio currently reflect your values and goals? Given the potential changes to capital gains rates, now may be the time to migrate to your ideal portfolio, whether that means transitioning to a responsible mandate or making other allocation adjustments. If you've thought about repositioning, consider accelerating your timeline.
- The same applies to investors planning to take capital gains to diversify a position, or to recognize income by converting a retirement account to a Roth. This year, you will benefit from knowing the magnitude of the tax hit—the same can't be said for next year.
- Currently, ordinary income producing alternative investments seem less appealing given the much lower tax rate on long-term capital gains and qualified dividends, but in a world without this preferred tax rate, these strategies become much more attractive.
- If the Biden plan outlined above is enacted, tax management will become more important to individual investors over the near term—particularly those with AGI near $1 million per year.
- Individuals will require more ways to "control" income recognition: for example, contributing more to a retirement plan, deferring stock option exercises, and being mindful about when to sell stock.
- Focusing on asset location may also help insulate investors from the impact of these changes. While retirement vehicles are already preferred over tax-inefficient investments, their capacity has limits. Strategies like a non-qualified private placement variable annuity or life insurance policy can serve as an effective way to shield additional investments from taxes, provided the investor has a long-enough time horizon.

ACT NOW ON ESTATE PLANNING

- The "window of opportunity" for the expanded exclusion may close earlier than originally thought. Some of the proactive steps that taxpayers can begin taking now include establishing wealth transfer strategies and reviewing existing trust and estate planning documents. Those in a position to fully use their applicable exclusion and GST exemption should take steps to preserve their ability to quickly make gifts by year-end.
- Trusts should be drafted and even funded through a promissory note or loan strategy with the option to forgive the note should that become necessary.
- Taxpayers should not wait for the outcome of the election to begin planning. Estate planning professionals, accountants, expert appraisers, banks, charitable institutions, and nearly everyone else necessary to effectuate a sophisticated estate plan will likely be overwhelmed if Democrats secure unified control of the House, Senate, and Oval Office.

MAINTAIN FLEXIBILITY

- Above all, remember: Tax laws change frequently. What may make sense today might not make sense in the future. Building some flexibility into your plan remains critical.

HOW A BILL BECOMES A LAW

If the Democrats control the House, Senate, and White House, they could potentially enact many of their proposed tax increases with a simple majority vote. How? Under normal circumstances, they'd have to overcome the Senate filibuster with at least 60 Senators, or a three-fifths majority ("supermajority") voting for cloture.[8] But since such a supermajority is highly unlikely for either party, essentially three methods remain.

First, Democrats could convince Republican colleague to cross the aisle and support their tax bill. Second, Senate leaders could eliminate the filibuster altogether since the Senate has full control over their own rule procedures. This option has long been considered the "nuclear option" because of its sweeping impact. The final and most likely route would be the budget reconciliation process, which requires only a simple majority.

Using budget reconciliation, Congress can change existing laws to align spending and revenue levels with a newly adopted budget. This route allows the House and the Senate to expedite matters by limiting debate to 20 hours.[9] Most recently, Republicans used the budget reconciliation process to enact the Tax Cuts and Jobs Act of 2017. However, as a result of the Senate's so-called Byrd Rule[10] —which blocks increases in the deficit beyond the "budget window"[11]—many provisions in the TCJA remain temporary and will revert back. In the case of deficit-reducing tax increases, this added hurdle would not apply.

In general, legislation becomes effective on the date of its enactment, unless otherwise specified. However, retroactive application of tax laws appears quite common and has been upheld by the Supreme Court on several occasions. If Democrats garner sufficient votes to reduce the gift and estate tax exclusion amount—or to increase rates—they could enact the legislation retroactively, as long as it is done in relatively short order, and not a "wholly new tax," such as a wealth tax. Even if they enact legislation several months into their term, retroactive application of the law to January 1, 2021 would almost certainly be deemed constitutional.

PRIORITIES FOR THE NEXT 100 DAYS

What should you look to accomplish between now and year-end?

1. USE YOUR EXCLUSION

If your aforementioned "Action Plan" involves tapping your basic exclusion and GST exemption, make this your top priority. The IRS clarified in late 2018 that if a taxpayer uses today's higher exclusion amount during the period it's available, a future "claw-back" tax will not be levied, as some practitioners had feared.

What's more, taxpayers will not be able to take the additional exclusion afforded by the TCJA "off the top" and preserve the pre-TCJA exclusion for future use. In other words, the ability to give away $11.58 million per person, $23.16 million per couple, represents a one-time opportunity that expires at the end of 2025—if not sooner.

2. GET BACK TO (COST) BASIS

Review existing trusts for general powers of appointment. Since the American Taxpayer Relief Act of 2012, estate planner's main focus has been to create estate inclusion for low-basis assets held in trusts in order to capture a step-up in cost basis at death. As a result, many trusts now include general powers of appointment, which may increase estate and income tax under the Biden tax plan. It may be necessary to remove these powers through trust modifications or decanting. Undoing prior basis planning like this can have tax consequences and should be reviewed carefully by your tax advisor.

[8] Senate Procedures Paragraph 2 of Rule XXII. See: https://crsreports.congress.gov/product/pdf/RL/RL30360.

[9] The Congressional Budget and Impoundment Control Act of 1974.

[10] Section 313 of the Congressional Budget Act of 1974, as amended; https://www.senate.gov/CRSpubs/95a2a72a-83f0-4a19-b0a8-5911712d3ce2.pdf.

[11] The "budget window" refers to the period covered by the budget resolution, and to any reconciliation directives included therein and the resultant reconciliation legislation. The longest budget window that has applied to a budget resolution and associated reconciliation legislation covered 11 years, including the current year. See: Bill Heniff Jr., The Senate's "Byrd Rule," https://www.senate.gov/CRSpubs/95a2a72a-83f0-4a19-b0a8-5911712d3ce2.pdf.

3. CONVERT TO A ROTH

If you have a large IRA, you may want to consider converting some or all of your retirement account to a Roth this year. Why now? The tax rate paid at conversion—relative to future rates—heavily influences the benefits of converting. An ideal Roth conversion would occur at a lower tax rate relative to the rate at which future IRA withdrawals would be taxed, assuming no conversion took place. Given potential near-term tax hikes, this could be a unique opportunity to convert at a lower rate. If paired with a charitable donation this year (see below), it could be even more attractive from a tax perspective.

4. CONSIDER AN EXPANDED CHARITABLE DEDUCTION

If you were planning to donate before year-end, the CARES Act expanded the amount you can deduct to 100% of your AGI for 2020[12]—provided the gift above normal AGI limitations is in cash and given directly to a public charity. Keep in mind, a combination of gifts of appreciated securities and cash could help optimize your gift. By giving appreciated stock, you could create a tax deduction this year while avoiding the capital gains on the sale of your stock. But consider the possibility that an income tax charitable deduction may be more valuable in 2021 than in 2020, if income tax rates were to increase.

5. ACCELERATE INCOME

To the extent meaningful income looms on your horizon—perhaps recognizing capital gains income from the sale of a business or other significant asset—you may benefit from recognizing that income now rather than waiting until next year. Today you have a degree of certainty on the potential tax obligation. Deferring until 2021 could mean facing higher tax rates. Some individuals may have more control over income recognition than others. In particular, corporate executives with stock options, stock grants, optional deferral programs, or net unrealized appreciation in their retirement accounts may have actions to consider before year-end. Similarly, consider postponing income tax deductions until 2021 if they may be applied against income that is taxed at a higher rate.

A RAPIDLY CLOSING WINDOW

No matter how things shake out politically after the general election, future wealth transfer taxes and income taxes will likely drift higher largely due to mounting deficits. The relevant planning question remains: how much time do we have to take advantage of income tax rates near historic lows[13] and an applicable exclusion and GST exemption at all-time highs?

Under current law, both wealth transfer taxes and individual income taxes are scheduled to increase after 2025, albeit, by much less than what many Democrats would prefer. Therefore, there's value in planning for tax increases no matter the outcome in November. But given the very real prospects of tax increases becoming retroactively effective as early as January 1, 2021, taxpayers should start planning today with the goal of positioning themselves to respond quickly and with little effort prior to the end of 2020. It is important for our clients to understand that attorneys, appraisers, trust companies, and every other relevant professional could be overwhelmed and unable to take new projects come November.

[12]Section 2205(a)(2)(A)(i) of the CARES Act creates a new category of charitable gifts referred to as a "qualified contribution," which is defined in Section 2205(a)(3) of the CARES Act as a cash gift made in 2020 in which an election is made, and is not made to a donor-advised fund, private foundation, or supporting organization.

[13] Nominal tax rates are near historical lows; however, data suggests that average income tax rates are fairly consistent over time, ranging from 23.2% in 2009 to 27.8% in both 1999 and 2000 for the top quintile of US households (1979–2016). See: https://www.taxpolicycenter.org/statistics/historical-average-federal-tax-rates-all-households.

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