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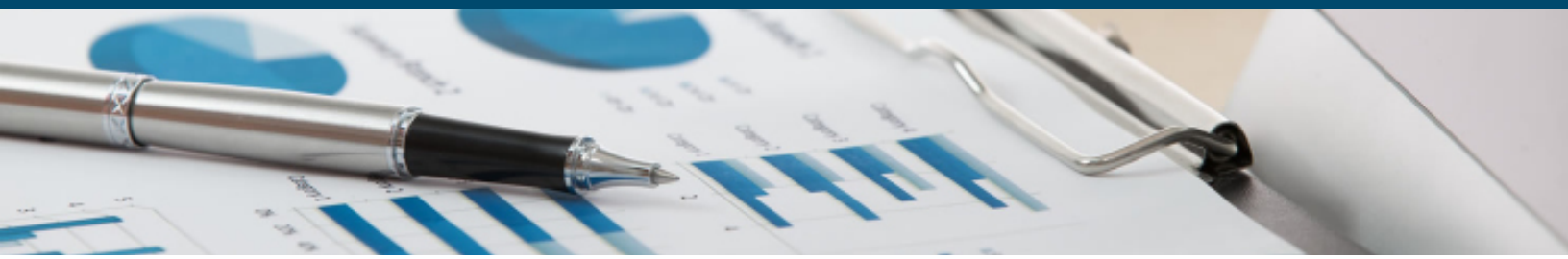

Post-Election Tax Planning Strategies to Consider NOW

With Joe Biden the presumptive 46th President-Elect, the Democrats maintaining the majority in the House, and control of the Senate currently deadlocked awaiting a January 5th runoff for the two Senate seats in Georgia, it is wise to consider how a potential blue sweep could impact the planning you do with your clients this year. Let's look at three planning opportunities you might want your clients to take advantage of before they are gone.

1 Reduction of Estate and Gift Tax Exemption

At the present time, a taxpayer has the ability to transfer, either during life as a gift or at death, assets valued at $11.58 million without the imposition of a federal gift or estate tax. Any property transferred in excess of the $11.58 million amount is taxed at 40%. The $11.58 million exemption amount is scheduled to be cut in half on transfers after December 31, 2025.

Initially, Biden proposed a reduction of the exemption to $3.5 million, but more recently he appears to propose pushing the 2025 reduction forward to 2021. Regardless, whether the exemption is cut in half or to $3.5 million, taxpayers with high net worth should consider making gifts exceeding the potential exemption amount prior to the end of the year.

Another reason to consider giving this year is Biden's proposal to eliminate the stepped-up basis benefit currently enjoyed by appreciated assets held at death. Today, if a taxpayer makes a lifetime gift of appreciated property, the person receiving the property takes over the basis of the taxpayer. So, if the recipient subsequently sells the appreciated property, they would pay income tax on the gain. However, if the recipient of the property inherits the property, they get a basis step-up equal to the fair market value of the property at date of death, avoiding any income tax on the appreciation. Biden's proposal eliminates the stepped-up basis, leaving lifetime gifts with no income tax detriment for the lifetime transfer tax benefits.

Finally, another reason to gift this year is the AFR and 7520 rates used in some of the more advanced gifting strategies such as grantor retain annuity trusts (GRAT) and intentionally defective grantor trusts (IDGT). These rates are at historic lows, which makes these techniques very attractive. A Biden administration is likely to modify the requirements to these techniques, making them less viable as wealth transfer strategies.

2 Increase to Capital Gains and Ordinary Income Tax Rates

While we are on the topic of changes proposed by Biden on appreciated capital gains property held at death, it's also important to consider his proposal to increase both ordinary income and long-term capital gains rates for high-income taxpayers.

One of Biden's most discussed proposals is to raise the ordinary income bracket from 37% to 39.6% for individuals with annual incomes over $400,000. Although, it is not clear whether this threshold applies to individuals or joint filers. While this proposal appears to be modest, it would also lower the income threshold at which the top rate would apply. Specifically, in 2020, a single filer with $400,000 of income would be in a 35% bracket. Alternatively, a joint filer with the same income would be in just the 32%, effectively eliminating the 35% tax bracket for married couples. Thus, the rate increase is likely to be more impactful for taxpayers at the lower end of the income threshold. Furthermore, tax bracket increases

only partially contribute to tax increases. Consequently, for income earners who would be impacted by the rate increase, this might be a good year to accelerate income.

Another feature of Biden's tax plan is the proposal to increase capital gains rate for taxpayers with over $1 million of income. Biden's plan calls for certain high-income taxpayers to pay ordinary income rates on realized gain. Specifically, for taxpayers with income over $1 million, the long-term capital gains rate would increase from 20% (23.8% if net investment income is added) to a proposed 39.6% (43.4%), or almost double. If it appears that the capital gains proposal is likely to become law, there are a variety of strategies to mitigate the impact. First, one easy solution is to harvest gains in 2020. The decision to accelerate a sale in such a manner may be especially appropriate for older, wealthy clients if Biden's plan to eliminate the step-up in basis at death also comes to pass. Going forward, high-income taxpayers might want to consider repositioning their portfolio to include more tax-deferred or tax-free assets, as they may provide a better tax-equivalent yield compared to other taxable assets.

Perhaps the proposal with the most controversy is the suggestion to eliminate the tax deduction for contributions to 401(k)s, IRAs, and other pre-tax retirement accounts and replace it with a flat 26% credit. The stated purpose of this proposal is to equalize the tax benefits provided by retirement plans. Currently, high-income earners receive most of the tax benefits because they receive a tax deduction at their higher tax rate. A 26% credit would have the impact of benefiting individuals in a lower tax bracket while motivating high-income earners to avoid pre-tax retirement accounts. Specifically, with the loss of the deduction, contributions to pre-tax/retirement accounts will be included in income and subject to tax. So, if a high-income earner in the 37% tax bracket contributed $20,000 to a retirement account, they would pay $7,400 taxes while only receiving a $5,200 tax credit. Furthermore, eventually the funds in the retirement account would need to be distributed at which point they will be taxed again. To avoid this tax situation, the solution will be for high-income earners to use Roth accounts and other vehicles such as life insurance that can provide tax-deferred accumulations and tax-free distributions.

3 Cap on Numerous Deductions

Biden's tax proposal also includes a cap on deductions, further increasing the effective tax rates of high-income earners. Specifically, Biden would cap itemized deductions to 28% and reinstitute the Pease limitation thereby reducing the value of itemized deductions by 3% of the amount that exceeds $400,000 up to an 80% overall reduction.

Usually, the value of deductions is correlated to the income tax rate. A higher tax rate normally makes a deduction more valuable, while a lower tax rate makes a deduction less valuable. When tax rates are increasing, the usual strategy is to delay deductions. However, Biden's proposal to cap deductions reduces the value of deductions for anyone above the 28% cap. Consequently, instead of delaying deductions to 2021 when tax rates are higher, anyone above the 28% tax bracket might want to accelerate or bunch deductions into 2020.

Life Insurance as a Potential Silver Lining

If Joe Biden ends up enjoying support of both the House and Senate, individuals with substantial net-worth and high incomes could see a significant increase in their taxes. Some of your clients may have already started to seek your advice, and whether the concern is the impact of estate tax on net-worth, the increased impact of income taxes on portfolio returns, or both, life insurance may be worth considering for their situation. Life insurance can be structured to provide liquidity to pay estate or income taxes triggered at death. Furthermore, high-income earning taxpayers who are looking for a tax-efficient asset to supplement retirement accounts may find life insurance as a viable option.