THE BIDEN TAX PROPOSALS

WILL THEY BECOME LAW, AND SHOULD ONE PLAN TO REDUCE THEIR IMPACT?

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As of the date of this writing, while there are challenges to be overcome, it is now widely accepted that Joe Biden will be the 46th President of the United States ("US"). As a result, it is important for US taxpayers and practitioners to understand the tax proposals that have been put forward by President-elect Biden and the Democratic Party. Some of the proposals discussed below are not directly attributable to the Biden campaign organization but logically follow from explicit Biden statements. Uncertainty about the control of the US Senate, the slim Democratic majority held in the House of Representatives, the selection of particular cabinet posts, and other political factors and policy priorities will affect whether and the extent to which these proposals are enacted into law. Even if they are enacted, the effective date of legislation is far from certain. Some tax practitioners and commentators recommend that taxpayers complete certain transactions before January 1, 2021 in order minimize the impact of any changes. That is completely understandable but, because there is so much uncertainty, year-end tax planning should be considered very carefully. In other words, it should involve no regrets if taxes do not change as anticipated.

With the above as background, one overwhelming theme is clear: high-income earners, wealthy individuals and trusts, and corporations are the main targets of tax increases. While many items will reverse or alter The Tax Cuts and Jobs Act of 2017 ("TCJA") and return aspects of the law to its status under the Obama administration, there will not be a wholesale repeal of the TCJA. Here are the changes and our point of view on the impact on taxpayers:

INCOME TAXATION OF INDIVIDUALS AND TRUSTS

The main income tax changes for individuals and trusts include the following:

- The top marginal ordinary income tax rate will be increased from 37% to 39.6% and will affect taxpayers having more than $400,000 of income. Prior to the TCJA, 39.6% had been the top tax rate for single taxpayers having taxable income above $400,000 (as adjusted for inflation). It is not clear whether the proposed $400,000 threshold refers to all individual taxpayers or only single taxpayers with married couples having a slightly higher threshold. It is likely that trusts will maintain their $12,950 threshold for the top tax rate or adjust slightly for inflation.
- The top tax rate for long-term capital gains and qualified dividends earned by taxpayers having more than $1 million of income will be increased from the preferential rate of 20% to 39.6%, the same rate as ordinary income.
- The basis step-up of capital assets at death will be eliminated.
- The 12.4% Social Security payroll tax will be imposed on wages over $400,000, shared equally by employers and employees. Currently this tax is applied only up to earnings of $137,700. Under this proposal, the tax would restart at the $400,000 wage level.
- The value of itemized deductions will be limited for taxpayers having income above $400,000. The details of this are not clear.
- A number of other credits, deductions and related items are proposed to ease the burden on low income taxpayers and students and also enhance the ability of low income taxpayers to save for retirement.

The changes will have a detrimental effect on high income taxpayers in general and specifically those who are highly compensated and rely on deductions to reduce their tax liability. Many of the changes affecting rates and deductions will also affect trusts. Foreign trusts and individuals engaged in a trade or business in the US (directly or indirectly through partnerships, branches and certain private equity investments) will be affected as well.

Pre-2021 year-end tax planning techniques to mitigate the impact of these items include:

- Accelerating transactions that generate income and capital gains; and
- Accelerating transactions that will generate deductions.

An accurate picture of a taxpayer's ultimate tax liability needs to take into account a number of related factors that can only be modeled with certainty once all tax legislation for a particular year is finalized. For this and the other reasons already stated, such techniques should be considered carefully.

TRANSFER TAXATION (GIFT, ESTATE, AND GENERATION-SKIPPING TRANSFER TAX) OF INDIVIDUALS

The main elements of transfer tax changes for individuals include the following:

- The top transfer (gift, estate and generation-skipping) tax exemption will be reduced to $3.5 million per person.
- The top transfer tax rate will be increased from 40% to 45%.
- As stated above, the basis step-up of capital assets at death will be eliminated. While this is an income tax item, the basis step-up is considered a part of comprehensive estate planning.

The TCJA had reduced the top rate to 40% and doubled the base transfer tax exemption from $5,000,000 to $10,000,000. The transfer tax exemption is presently an inflation adjusted amount of $11,580,000. The TCJA also included a sunset which cuts the exemption in half after December 31, 2025. In this context, the Biden proposals seem material. However, the estate tax still affects relatively few taxpayers and the Biden exemption will still be very generous as compared to similar exemptions on death taxes imposed in other countries. An annual wealth tax proposed by other Democratic candidates has not been endorsed by Biden, but some Progressive Democrats still like the idea.

Most non-US persons (individuals who are neither citizens nor residents of the US) holding US investments will not be affected by a change in the exemption, but they will be affected by a change in the top transfer tax rates. Non-US persons who are residents of certain treaty countries (e.g. Canada and the United Kingdom) will be hurt by a change in the exemption because tax treaties with such countries confer benefits that are contingent on the level of the exemption.

Pre-2021 year-end tax planning techniques to mitigate the impact of these items include:

- Accelerating large gifts to family members and trusts;
- Selling appreciating assets to family members and trusts in exchange for low interest rate notes; and
- Having family members with highly appreciated assets sell or give such assets to family members with estates below the transfer tax exemption in order to obtain a basis step-up when the recipient or buying family member dies.

As is the case with the income tax proposals, the legislative picture is far from certain, and such techniques should be considered carefully and with expert advice.

CORPORATE AND BUSINESS INCOME TAXATION

The main elements of income tax changes for corporations, businesses and their shareholders include the following:

- The top corporate income tax rate will be increased from 21% to 28%. This highest marginal corporate tax rate prior to the TCJA was 35%.
- A minimum 15% tax on book income will be imposed.

- A minimum 21% global income tax will be imposed on GILTI (so-called "global intangible low taxed income" which must be paid by US shareholders of controlled foreign corporations).
- Tax-free rollovers of appreciated real estate will be limited or eliminated and opportunity zone rules will be tightened.
- A number of other changes will reduce preferences or increase taxes for certain industries (including those offshoring of productions and jobs or involved in carbon generation, pharmaceutical advertising or financial transactions) and increase preferences for small businesses and certain industries (including those returning jobs and production to the US or involved in renewable energy).

The TCJA enacted beneficial changes for US businesses in general, but it also imposed complicated rules on many US businesses having offshore operations and US shareholders of controlled foreign corporations. The Biden proposals would roll back some of the benefits of the TCJA and further tighten some of the TCJA rules affecting international businesses.

A corporation or business with mostly US source income might consider accelerating the recognition of income before January 1, 2021. The rules relating to businesses with foreign income and controlled foreign corporations are exceedingly complex. Therefore, given the uncertainty already discussed, planning to reduce the impact of proposals affecting cross-border businesses should also be viewed cautiously.

CONCLUSION

Taxpayers and their advisors should always remain aware of potential tax legislation. However, as the old saying goes, "don't let the tax tail wag the dog". In this uncertain political climate, that saying carries more than a grain of truth. We are always available to discuss these issues with you.

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