Taxes and the 2020 Election

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Introduction

The November 3 general election is less than two months away. Although the COVID-19 pandemic is still a major part of the fiscal policy debate in this election cycle, one of the main issues on the ballot this year will be the Tax Cuts and Jobs Act (TCJA), which significantly raised the threshold for the imposition of income and transfer taxes for many individuals, estates and pass-through entities. Many provisions of the TCJA are scheduled to sunset (expire) at the end of 2025 for budgetary and procedural reasons, but the question is whether the TCJA will survive until the end of 2025.

Our goal is to provide a balanced high-level overview and comparison of how each candidate's proposals would work, along with a side-by-side comparison of each candidate's positions on key issues.

Please note, however, that while both Trump and Biden have put forth proposals, very little detail is available on each. Additional details may emerge during the campaign so both tax proposals could change over time. It is also important to note that tax legislation begins with Congress, not the White House, so any tax legislation that emerges must be agreed upon by both the House of Representatives and the Senate and then signed by the president before it becomes law. This could lead to action or inaction depending on whether either party can secure a majority in Congress and even then would require full alignment across the party voting lines to enact change.

Income Tax Comparison

Ordinary Income

The Democratic tax proposal would raise the top tax bracket back to 39.6% from 37% for taxable income >$400,000. Small changes to the other six tax brackets would include the following: 10%, 15%, 25%, 28%, 33%, and 35%.

The Republican tax proposal would keep the top tax bracket at 37% and make the TCJA brackets permanent.
Current tax brackets include 10%, 12%, 22%, 24%, 32%, 35% and 37%.

Possible Strategy: Accelerate ordinary income items this year to take advantage of lower ordinary income tax-rates (e.g., bonus acceleration, exercise NQSOs, convert traditional IRAs to Roth IRAs).

Capital Gains

The Democratic tax proposal would eliminate the 20% tax rate on long-term capital gains and apply the top ordinary income tax rate (39.6% rate + 3.8% Medicare surtax) for individuals with taxable income >$1,000,000.

The Republican tax proposal would keep the existing structure in place.

Current tax law is 20% + 3.8% Medicare surtax = 23.8%. 23.8% rate applies to individuals with taxable income greater than $441,500.

Possible Strategy: Recognize long term capital gains for 2020 to use the lower rates available now. Consider accelerating taking capital losses to offset capital gains.

Itemized Deductions

The Democratic tax proposal would cap full itemized deductions for single filers and married couples filing jointly to those with blended tax rates of up to 28%. Individuals would receive full itemized deductions if the blended tax rate is < or = 28%. For blended rates >28%, itemized deductions will be gradually lowered according to the percentages set forth under the Pease limitation (see below for detailed explanation).

Certain itemized deductions that were capped would be brought back as follows:

Deduction for state and local taxes (SALT) would be uncapped, allowing full SALT deduction, subject to decrease due to Pease limitation and alternative minimum tax (AMT) calculation.

Real estate property tax deduction would be uncapped, subject to decrease due to Pease limitation and AMT calculation.
Possible reinstatement of mortgage interest deduction on mortgages up to $1,000,000.

The Republican tax proposal would keep the existing structure in place.

The current tax law has limited or eliminated many itemized deductions. The standard deduction was increased to $12,000 for single filers and $24,000 for married couples filing jointly in 2018 and indexed for inflation. For 2020, the standard deduction is $12,400 for single filers and $24,800 for married couples filing jointly.

The mortgage interest deduction is limited to $750,000. Home equity loan interest may be included as part of the $750,000 limit if the home equity loan is used specifically for improvements to the home, not for non-home-related improvements.

SALT and Real estate property tax deductions capped at $10,000 total.
Theft, personal casualty, tax preparation fees, and unreimbursed employee expenses are all eliminated.

Pease Limitation

Democratic tax proposal would reinstate the Pease limitation for individuals with taxable income >$400,000. The Pease limitation was enacted in 1992 to limit the amount of itemized deductions available for high-income earners. It was fully repealed under President Bush in 2009, reinstated by President Obama in 2013, and repealed again under President Trump in 2017. Pease limitation starts reducing taxpayers' itemized deductions once they reach a certain threshold adjusted gross income (AGI) amount. Itemized deductions are lessened by 3% for every $1 above the threshold amount. The reduction is limited to 80% of your total itemized deductions.

The Republican tax proposal would keep the existing structure in place.

The current tax law has repealed the Pease limitation

Alternative Minimum Tax

Democratic tax proposal may reinstate the alternative minimum tax (AMT) for most taxpayers by reinstituting the pre-TCJA AMT exemption phase-out calculation.

Republican tax proposal keeps the existing structure in place.

The current maximum AMT tax rate is 28%. AMT exemption amounts are $72,900 for single filers and $113,400 for married couples filing jointly. Exemption phase-outs begin at $518,400 for single filers and $1,036,800 for married couples filing jointly. Therefore, most taxpayers do not fall within AMT, because by the time the exemption phases out, their blended tax rates are >28%.

Possible Strategy: Accelerate AMT income items (exercise ISOs.)

Social Security (Payroll) Tax

Democratic tax proposal would add an additional 12.4% Social Security payroll tax (6.2% on individuals and 6.2% on employers) for taxpayers with earned income >$400,000. Under the Biden proposal, no payroll tax will be owed on earned income between $137,701 and $400,000.

Republican tax proposal keeps the existing tax structure in place.

The current tax law provides a Social Security payroll tax of 6.2% on employees' wages up to $137,700. Social Security wages are indexed for inflation on an annual basis.

20% Pass-Through Income Tax Deduction for Small Businesses

Democratic tax proposal would phase out the 20% pass-through income tax deduction for small business owners with taxable income >$400,000.

Republican tax proposal seeks to permanently maintain the 20% deduction.

The current tax law provides a 20% pass-through income tax deduction.

Taxation of Carried Interest

Democratic tax proposal proposes that the distribution of carried interest to private equity principals be taxed as ordinary income.

Republican tax proposal proposes that the distribution of carried interest to private equity principals be taxed as ordinary income.

The current tax law provides that carried interest is taxed at preferential capital gains income tax rates. IRS has just issued proposed regulations that state, in part, that for carried interest to qualify for capital gains treatment there must be a holding period of at least three years before the carried interest is distributed to the private equity principal. If less than three years, carried interest distribution would be treated as ordinary income.

Transfer Tax Comparison

Estate and Gift Tax

Democratic tax proposal: consensus opinion is that the estate tax exemption may be lowered to either the pre-TCJA exemption of $5,600,000 (what the exemption would have been in 2018 if the TCJA was not enacted) or the pre-2010 exemption of $3,500,000.

The Republican tax proposal would keep the current exemption structure in place, indexed for inflation.

Current estate tax exemption amount is $11,580,000 per individual, indexed for inflation.

Possible Strategy: Grantor retained annuity trust (GRAT), Intentionally defective grantor trust (IDGT), Spousal limited access trust (SLAT), or Irrevocable grantor trust (IGT) to transfer assets out of the estate and take advantage of the $11,580,000 gift tax exemption in 2020.

Democratic tax proposal: consensus opinion is that the Gift tax exemption may be lowered to either the pre-TCJA exemption of $5,600,000 or the pre-2010 exemption of $1,000,000.

The Republican tax proposal would keep the current exemption structure in place, indexed for inflation.

Current gift tax exemption amount is $11,580,000 per individual, indexed for inflation.

Possible Strategy: GRAT, IDGT, SLAT, or IGT to transfer assets out of the estate and take advantage of the $11,580,000 gift tax exemption.

Democratic tax proposal does not mention increasing top estate and gift tax rate from the current 40% to 45%, but this was talked about during the Democratic primary debates.

The Republican tax proposal would make the current 40% estate and gift tax rate permanent.

The current top rate is 40%

Step-Up in Basis at Death

Democratic tax proposal would repeal the step-up in basis at death. The proposal is silent on whether, in addition to estate tax being due, there will be capital gains tax due at death on the appreciation of assets attained during the lifetime of the deceased.

The Republican tax proposal would keep the step-up in basis at death.

Current law provides for a full step-up in basis at death on non-retirement based assets.
Possible Strategy: Make gifts now to take advantage of a higher gift tax exemption amount by establishing a GRAT, IDGT, SLAT, or IGT to transfer assets out of the estate. This would mitigate the loss of the step-up in basis as assets gifted would not qualify for a full step-up in basis if the Democratic tax proposal is enacted in the future.

Gifting Strategies

Grantor Retained Annuity Trust (GRAT): Gift of appreciating assets to an irrevocable trust in exchange for annuity interest. Remainder interest passes to beneficiaries when the trust term ends. The value of the gift is discounted based on the payout rate and term of years of the GRAT.

Intentionally Defective Grantor Trust (IDGT): Gift or sale of appreciating assets to an irrevocable trust. At least 10% of the value of the trust ("seed") must be gifted to the trust to qualify for IDGT status. The remaining assets (up to 90%) may be sold to the trust in return for a promissory note. The designated interest rate for the promissory note would be set at the current historically low applicable federal rate. This freezes the value of the asset transferred to the IDGT in the grantor's estate. All future appreciation above the interest rate on the promissory note is removed from the estate. The grantor is responsible for all tax due on income generated within the IDGT, which provides an additional benefit to the trust beneficiaries.

<u>Spousal Lifetime Access Trust (SLAT):</u> Each spouse transfers their interest in an asset to a SLAT for the benefit of the other spouse. The beneficiary spouse serves as a trustee of the SLAT. By transferring the asset during their respective lifetimes, each spouse "freezes" the value of the asset as of the date the transfer is made. Future appreciation is not subject to gift or estate tax, and the asset itself will not be included in either spouse's estate. However, the beneficiary-spouse will receive distributions from the SLAT for his or her health, education, maintenance, and support, thereby enabling continued access to the asset and its income during the spouses' lifetimes.

<u>Irrevocable Grantor Trust (IGT):</u> Gift to an irrevocable trust. All future appreciation is removed from the estate. IGT usually includes language that allows the grantor to "substitute" assets of equal value to the trust to reacquire trust assets. This "power of substitution" makes the trust a "grantor" trust. Therefore, the grantor is responsible for all tax due on income generated within the IGT, which provides an additional benefit to the trust beneficiaries.

<u>Other Issues</u>

A slight possibility exists that gifts made in 2020 will be retroactively negated if new law passed during 2021 only allows gifts made before January 1, 2020 would be grandfathered. The more likely scenario is that gifts made before January 1, 2021 would be grandfathered.

Grantor retained annuity trust (GRAT) rules to be revisited to eliminate short-term GRATs introducing greater mortality risk. This has been debated for the past 10 years, because of the use of "zeroed-out" GRATS as a way of gifting assets to family members, especially when interest rates are low, as they are today, at little or no gift tax cost. The short term nature of the GRAT allows individuals to continuously roll the assets of the GRAT into new GRATS.

Applicability of valuation discounts on Family limited partnership (FLP) and Limited liability company (LLC) interests being transferred to be revisited. IRS proposed regulations in August 2016 would have eliminated valuation discounts for lack of marketability and lack of control. Proposed regulations were pulled back after the election of President Trump.

Possible Strategy: Identify assets that may benefit from valuation discounts and start the valuation process in anticipation of gifting. Must recognize the risk associated with the possibility of the retroactive repeal of gifting discounts.

The table below provides an overview of how Democratic presidential nominee Joe Biden and President Donald Trump would address the taxation of high-net-worth individuals and how their respective proposals compare with current law.

Personal Income Tax Plan Comparison

	Current Law	Biden	Trump
Personal Income Tax	37% top bracket (>$518,401) Sunsets 12/31/25	39.6% top bracket (>$400,000)	37% top bracket (>$TBD) Made Permanent
Capital Gains Tax	• 20% rate • 3.8% Medicare surtax • Carried interest treated as capital gains	• 39.6% rate (>$1,000,000) • 3.8% Medicare surtax • Carried interest treated as ordinary income	• 20% rate • 3.8% Medicare surtax • Carried interest treated as capital gains
Personal Social Security & Medicare Taxes	6.2% on wages up to $137,700 (indexed for inflation)	6.2% on wages up to $137,700 and over $400,000	6.2% on wages up to $137,700 (indexed for inflation)

Income Tax Deductions - Plan Comparison

	Current Law	Biden	Trump
Itemized Deductions	• Pease limitation on deductions repealed in 2017 • State and local and real estate tax deduction limited to $10K • 20% deduction for qualified small business income	• Reinstate Pease limitation on deductions • No limit on SALT or real estate deductions, except overall deduction limits • Phase out small business pass-through deduction	• Pease limitation on deductions stays repealed • State and local and real estate tax deduction limited to $10K • 20% deduction for qualified small business income made permanent
Alternative Minimum Tax	Impact muted by increased phase-out limits	Return to pre-TCJA exemption levels. Full benefit of itemized deductions capped at 28% rate	Same as current law

Personal Wealth and Estate Tax Comparison

	Current Law	Biden	Trump
Estate Tax	• Exemption: $11.58M • Basis step-up at death	• Exemption lowered to pre-TCJA levels • Repeal step-up in basis at death	Same as current law
Gift Tax	Current exemption: $11.58M	Exemption lowered to pre-TCJA levels	Same as current law
Transfer Tax Rate	Current top rate: 40%	Top rate to 45%	Same as current law

Corporate Income Tax

Democratic tax proposal would raise the corporate income tax rate from 21% to 28%.

The Republican tax proposal would keep the corporate income tax rate at 21%.

The current tax law has a corporate income tax rate of 21%.

Democratic tax proposal would create a minimum income tax on corporations with book profits of $100 million or higher. The minimum tax would be structured as an alternative minimum tax—corporations would pay the greater of their regular corporate income tax or the 15% minimum tax while still allowing for net operating loss (NOL) and foreign tax credits.

The Republican tax proposal would not create a minimum corporate income tax.

The current tax law provides that corporations will be taxed at a rate of 21% on all income.

The general election is less than two months away, and it is not clear which presidential candidate and which political party will be setting the tax policy agenda when the next administration begins in 2021. In addition, as the nation continues to grapple with the economic uncertainty stemming from the COVID-19 pandemic, the tax proposals put forward by Biden or Trump, depending on the outcome of the election, may be influenced by factors that are unknown at this time as well as by the status of the economic recovery.

Significant tax law changes may occur over the next few years, and it is never too early to start evaluating the proposals being put forward, modeling potential outcomes, and planning to take appropriate action that fits your goals and objectives if and when these proposals go from a possibility to the law of the land.