April 2021

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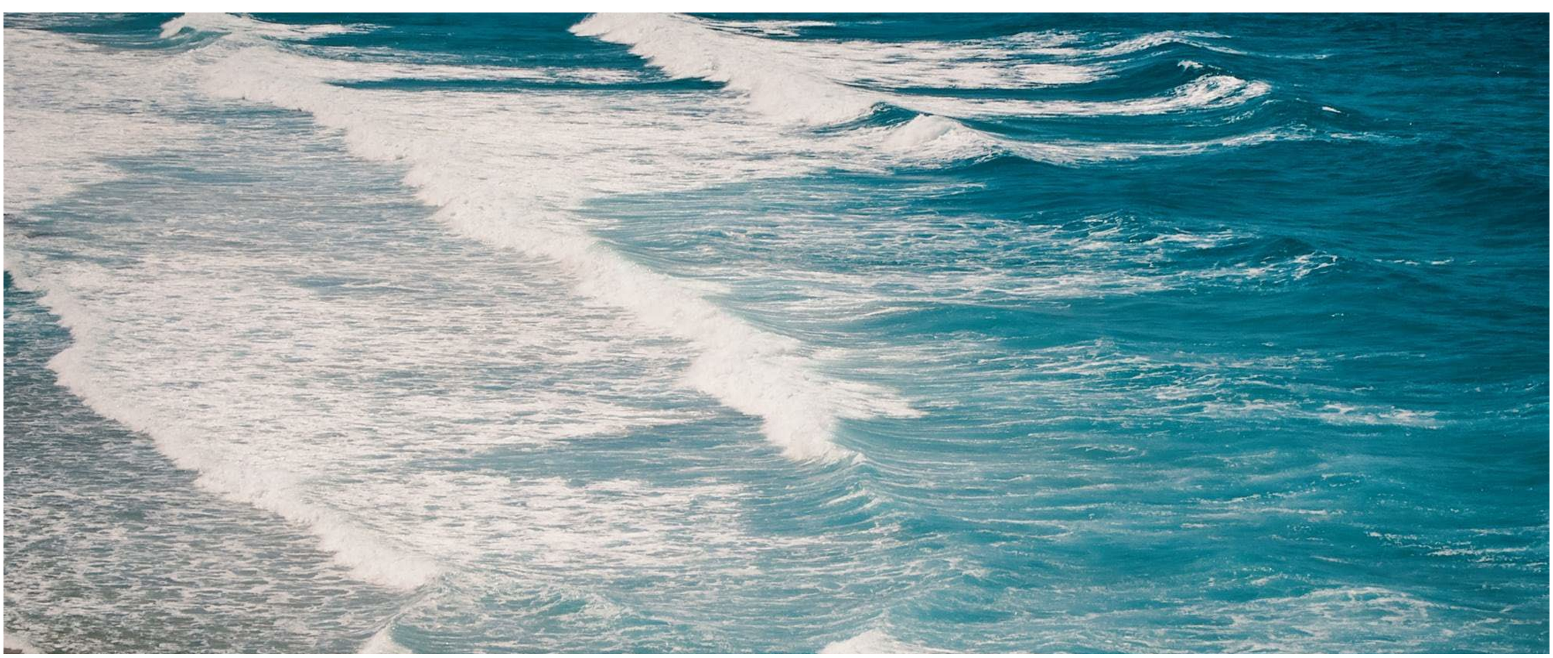
Scanning the Horizon in a Sea of Noise

As anticipated, the first quarter of 2021 offered many opportunities for legislators to highlight potential tax law changes in the political news cycle. The new administration has continued to introduce record breaking spending packages in response to the global pandemic, and with a Democratic majority in both houses of Congress, tax changes, in some form, appear inevitable.

However, predicting the nature, magnitude and timing of potential changes is much more elusive. Over the last several weeks we have seen Democratic proposals addressing hot button issues such as the corporate tax rate, estate and gift tax exemption levels, estate tax rates and the elimination of the step-up in basis at death. Some of the provisions in these proposals represent dramatic deviations from current law and are, appropriately, garnering a lot of attention.

With so much uncertainty, many individuals are finding it increasingly difficult to feel comfortable that their financial plans are structured to meet their needs and goals in a choppy sea of proposals. That discomfort is natural, but the current environment presents great opportunities to revisit financial and estate plans before changes are enacted. It is also important to recognize that the more dramatic provisions, some of which are covered in this piece, are still in the early proposal stage and could look materially different if passed into law.

It is our view that good planning involves constant monitoring, and the last few years have certainly been no exception. What continues to make the planning process unique in our current environment is navigating the legislative opportunity in an effort to act ahead of potential changes. When it comes to impending tax law changes, we are all constantly "Scanning the Horizon in a Sea of Noise" trying to drill down on what is most likely to happen, and when.



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Current Environment & Activity in Washington

Much of the conversation surrounding potential tax law change is rooted in the current political environment in the United States. To set the stage for what might happen in the rest of 2021, we would be wise to first review some key events from the first quarter:

Composition of Executive and Legislative Branches

- On January 20, 2021 Joseph R. Biden, Jr. and Kamala D. Harris were sworn in as the President and Vice President of the United States.
- On January 5, 2021 the Georgia run-off resulted in the Democrats winning both seats officially flipping the state Blue for the first time since the 1960s.
- Post November Election, the House of Representatives is Democratic (221 seats to 210 seats).

Procedural Implication

- The Senate has a procedural rule allowing any Senator to filibuster but 60 Senators can end the filibuster. One exception to this rule is the Budget Reconciliation process. With a 50-50 split in the Senate, Democrats can pass legislation through the Budget Reconciliation process, which calls for just a simple majority (50 votes, and Vice President Kamala Harris as a tie-breaker).
- The Budget Reconciliation process has been used previously to pass major tax legislation: – 2001 Tax Act – 2017 Tax Cuts and Jobs Act.

Biden Administration Activity to Date

- On March 11, 2021 passed the $1.9 Trillion American Rescue Plan Act of 2021 using the budget reconciliation process described above.
- On March 30, 2021 proposed a $2 Trillion infrastructure bill with the hope of negotiating bipartisan support. Initial proposal includes many of the corporate tax items President Biden campaigned on, such as increasing the corporate tax rate to 28%.
- It is widely expected that a second bill focused on "human infrastructure" initiatives will follow the current infrastructure bill. That bill is expected to include individual income and estate tax law proposals.

Anchoring the Negotiations in Washington

Over the past several weeks the process to enact tax law changes in Congress has started to pick up. Specifically, two bills that would dramatically alter the United States transfer tax regime have been introduced.

One spearheaded by Senator Bernie Sanders (I-VT) titled the "For the 99.5% Act" (Sanders Bill) and another spearheaded by Senator Chris Van Hollen (D-MD) titled "Sensible Taxation and Equity Promotion Act of 2021" (Van Hollen Bill).

Additional detail on the provisions in these bills follows. It is important to note that final law will likely differ materially from these bills but acknowledging and digesting their provisions is key as we continue to lock on to what future tax law might look like.

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Sanders Bill

The Sanders Bill focuses primarily on increasing the estate and gift tax burden associated with the transfer of wealth to future generations. Specifically, the bill calls for the following:

- Reduction in Lifetime Gifting Exemption from 2021 amount of $11.7 Million per person to $1 Million per person.
- Reduction in Estate Tax Exemption from 2021 amount of $11.7 Million per person to $3.5 Million per person.
- Introduction of a more progressive estate tax rate structure with a maximum marginal rate of 65% on taxable estates greater than $1 Billion. The bill also introduces additional rate brackets at 45%, 50% and 55% on taxable estate assets over $3.5 Million, $10 Million, and $50 Million, respectively.
- Elimination and restriction of advanced transfer strategies such as valuation discounts, Grantor Trusts, and Grantor Retained Annuity Trusts (GRATs).
- Establishing a uniform maximum trust length of 50 years to limit the ability to place assets in Generation Skipping Transfer Tax Exempt trusts over many lifetimes.
- The estate tax proposals are not intended to be retroactive and call for an effective date of January 1, 2022. Other provisions would be effective on the date of enactment.

Van Hollen Bill

The Van Hollen Bill looks to change the treatment of tax basis of property that passes through a deceased individual's estate.

Currently, assets passing through an estate receive a step-up in basis that eliminates any unrealized appreciation at death. This step-up results in heirs receiving assets with fair market value very close to cost basis allowing them to sell those assets with very little incremental tax friction. Specifically, the bill calls for the following:

- Elimination of the automatic step-up in basis at death for any unrealized appreciation over $1 Million.
- The bill treats death as a "realization event" meaning that not only is there no step-up, but capital gains taxes must be paid at death on the unrealized appreciation over $1 Million.
- The bill would allow for the income tax liability generated from the deemed sale at death to be paid over a 15-year period.
- Capital gains taxes incurred at death would be deductible from the decedent's estate for estate tax purposes.
- Property transferred during life would also be treated as sold at fair market value, representing a realization event. Taxpayers would be able to use $100 Thousand of the $1 Million exemption on gifts made during life to avoid capital gains taxes on the deemed sale.
- The proposal is intended to be retroactive and calls for an effective date of January 1, 2021.

To reiterate, while these proposals represent dramatic shifts in tax law they are still in the early stages of development and there will be a great deal of negotiation in the coming weeks and months before any of these provisions could be signed into law.

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What's Next

Despite the recent noise, the Budget Reconciliation process still implies a more muted rate of change. Tumultuous shifts could stall negotiations and anchoring may eventually erode into compromise. When the sea settles, it seems likely that the key areas of focus will settle on the highest revenue raising items and those with the least political culpability. In sum, those appear to be:

- An increase in the corporate tax rate to 28% from the current 21%.
- An increase in ordinary income tax rates to pre-TCJA levels on individuals making more than $400,000 per year, with a top-bracket of 39.6% instead of 37%.
- A reduction in the estate tax exemption from the current historic highs of $11.7 Million per person to something between $3.5 Million and $6 Million (inflation adjustment on $5.25 Million).
- An increase in the estate tax rate above the current 40% rate. It is tough to say whether that will be a flat increase to something like 45% (as in the original proposal) or if it will incorporate a tiered structure like the new "99.5% Act" proposed by Senator Sanders.

Although changes to capital gain rates do not make this list, the cost is outsized for individuals with large unrealized gains. So, it seems, the largest controllable planning opportunities surround estate and capital gains taxes. For any individuals with the means and desire to transfer wealth to the next generation, 2021 feels like the opportune moment to make irrevocable transfers. And for those with large capital gains, whether in the form of investment or an operating business, you should be considering sales before year-end. Again, we believe the chance for massive change here to be low but the cost of not acting now could be high.

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Key Individual Income Tax Provisions

	Current Law	President Biden Campaign Proposal
Ordinary Income	10%: \$0 – \$9,875 12%: \$9,876 – \$40,125 22%: \$40,126 – \$85,525 24%: \$85,526 – \$163,300 32%: \$163,301 – \$207,350 35%: \$207,351 – \$518,400 37%: \$518,400 – More	10%: \$0 – \$9,525 15%: \$9,526 – \$38,700 25%: \$38,701 – \$82,500 28%: \$82,501 – \$157,500 33%: \$157,501 – \$200,000 35%: \$200,001 – \$400,000 39.6%: \$400,001 – More *No formal rate structure announced but expressed desire to roll back to pre-TCJA levels.
Itemized Deductions	Common deductions include mortgage interest, charitable donations, state and local taxes and investment interest. State and local taxes limited to \$10,000.	• Itemized deductions would carry a maximum tax benefit of 28% of total deductions. • Reinstatement of the 3% Pease Limitation.
Capital Gains	Taxable Income: 0%: \$0 – \$40,000 15%: \$40,000 – \$441,450 20%: \$441,451 + *Applicable to Long Term Capital Gains and Qualified Dividends	Long Term Capital Gains and Qualified Dividends would be taxed at ordinary rates for taxpayers with annual income greater than \$1 Million.
Carried Interest	Treated as long-term capital gain if held for at least three years.	Taxed as ordinary income.
Payroll Tax	• 6.2% Social Security tax on wages up to \$137,700 (employer and employee). • 1.45% Medicare tax on all wages (employer and employee). • 0.9% Medicare tax on wages over \$200,000, \$250,000 if married (employee only).	Eliminate Social Security tax exemption for wages above \$400,000 (wages between \$137,700 and \$400,000 would still not be taxed).

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Key Estate & Gift Tax Provisions

	Current Law	President Biden Campaign Proposal
Exemption Thresholds	$11.7 million per individual (indexed for inflation).	President Biden has been silent, but the Biden-Sanders task force expressed support for returning estate taxes to the historical norm. The pre-TCJA exemption level was $3.5 Million per individual, and the Obama Biden Administration had implemented $5.25 Million per individual (adjusted for inflation) under ATRA in 2013. Sanders recently formally proposed $3.5 Million estate tax and $1 Million gift tax exemptions.
Basis Step-Up	Heirs receive an increased basis in inherited assets equal to the current fair market value.	Eliminate the step-up in basis for inherited assets.
Tax Rate	Top Rate of 40%.	Top Rate of 45%. New Senator Sanders proposal incorporates graduated rates 45 – 65%.

Key Corporate Tax Provisions

	Current Law	President Biden Campaign Proposal
Corporate Tax Rate	21%	28%