Southern Arizona Estate Planning Council

Estate Planning and the 2020 Presidential Election

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Outside of the practice of law, Darren enjoys spending time with his wife and children, taking them on family adventures. Darren also enjoys training for and competing in Ironman and other triathlon events, supporting ASU Sun Devils and Georgetown Hoyas athletics, and spending time outdoors in Arizona.

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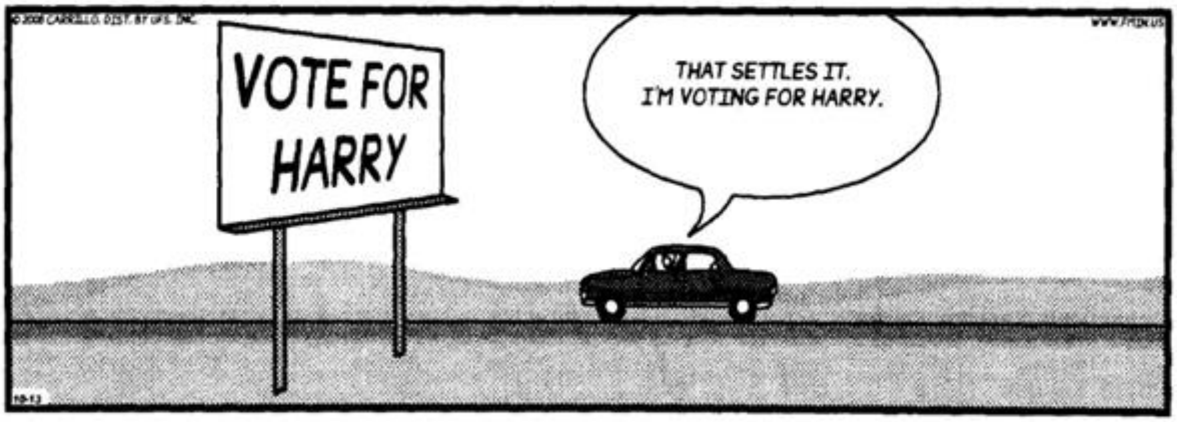

Introduction.

Essentially for over 100 years now, the estate tax and other areas of the tax code targeting high net worth individuals have been political footballs kicked around by nearly every candidate running for President of the United States. The 2020 election is certainly no different. Due to uncertainty created by this election and its impact on various provisions of the Internal Revenue Code, the time for clients to act on certain estate planning transactions may be running out. This presentation first focuses on the current tax laws in place in 2020 that estate planning attorneys and other practitioners operating in the private wealth planning area ordinarily advise their clients on, such as income and capital gain taxes, gift tax, estate tax, and generation skipping transfer tax. Following a review of these areas of the tax code and their application to estate planning clients, this presentation will shift into a discussion on what practitioners should do if the presidential election brings change to the oval office and forthcoming tax law changes along with it.

Depending on the result of the election, it is possible, although potentially unlikely, to see new tax law legislation passed in 2021 *and* be retroactive to January 1, 2021. If this were to occur, it could have a huge impact on high net worth clients in the future if there is a failure to act before the end of 2020. While this presentation certainly delves into conversations about political candidates and their respective parties, it is *solely* focused on the tax laws in place now versus potential tax laws that *could* be implemented based upon proposals of the candidate running against the incumbent.

Regardless of the outcome of the 2020 election, the presentation will go into significant detail on various estate planning transactions such as revocable living trusts, grantor retained annuity trusts (GRATs), intentionally defective grantor trusts (IDGTs), irrevocable life insurance trusts (ILITs), etc., which will be helpful under most all tax code structures.

General Overview.

As the 2020 election rapidly approaches, Federal tax laws may once again be changed by our elected officials. The Republicans and Democrats have both discussed reforming (or further reforming) the federal tax laws after the election, with income tax rates and brackets, capital gains taxes, and estate, gift, and generation skipping transfer tax rates and exemptions being impacted.

1. ***Proposed Changes to Federal Corporate and Individual Income Tax Rates***

Joe Biden and the Democratic proposals have included increasing the top U.S. corporate tax rate to 28%, which is currently at a 21% tax rate that was set in the Tax Cuts and Jobs Act of 2017 ("TCJA"). Additionally, the Democrats have discussed imposing an alternative minimum tax on corporations of an additional 15% for certain corporations meeting income thresholds. Prior to President Trump and the Republicans enactment of the TCJA, the top corporate tax rate had been 35%.

An additional proposal by Democrats has been to raise the top individual income tax rate from the current 37% maximum rate to a maximum 39.6% for taxpayers earning over $1 million of income per year. Furthermore, Democratic proposals have discussed the elimination of the current capital gains rates for taxpayers earning over $400,000 in a taxable year and instead treating such taxpayers gains as ordinary income. This would mean that so-called high income earners (*i.e.*, over $400,000 of income per year) would pay a tax rate of 39.6% instead of capital gains rates of 15% or 20% (or 23.8% due to the net investment income tax). The Republican's proposal, which has not received nearly as much attention, would potentially reduce the maximum capital gains rate to 15% (from the current 20% / 23.8% level).

While this presentation will not cover this particular topic, it is important to note that if the Democrat's proposal were to be implemented and the capital gains rate was likely to increase after the November election the following year in 2021 or 2022, then businesses will strongly need to consider the consequences and potentially explore whether it is better from a tax perspective to restructure and become a pass-through entity (rather than remain as a C corporation).

In conjunction with capital gains rates increasing, there also has been discussions regarding the elimination of the Section 199A pass-through deduction. One of the original purposes of Section 199A was to enable the taxation of non-corporate business income more similarly to corporate business income due to TCJA's lowering of the corporate tax rate to 21%. In general, Section 199A provides a 20% deduction for qualified trade or business income; this effectively reduces an individual's top tax rate from 37% to 29.6% for eligible pass-through owners. However, if the tax laws change and corporate income tax rates are raised, then there would be less need for Section 199A deductions in order to equalize corporate business ownership with other forms of business ownership.

2. ***Proposal to Eliminate Section 1031 Tax-Deferred Exchanges of Real Estate***.

A somewhat surprising Democratic proposal in regard to the upcoming election is for the elimination of Section 1031 tax deferred exchanges of real estate for investors over a certain income threshold. Section 1031 tax deferred exchanges have essentially been part of U.S. income tax laws since the inception of the Internal Revenue Code. After the passing and enactment of TCJA, Section 1031 exchanges are generally now limited to only exchanges of real property. In general, Section 1031 currently allows the seller of real estate to reinvest the sales proceeds into a new real estate investment within a stated time period, and thus, defer recognizing the gain on the sale of that real estate. The result of Section 1031 over the years is that real estate investors have been able to "grow" their deferred gains, by reinvesting those gains into other properties without paying income tax. If the real estate investor keeps reinvesting their real estate gains by using Section 1031 until that investor's death, then that investor's estate receives a step-up in income tax basis, thereby eliminating forever the built-in tax on that real estate investment.

3. ***Federal Gift and Estate Tax Laws May Change***.

After the contentious 2016 election, the unified federal gift and estate tax exclusion amount increased under the TCJA. Thus, in 2020, after adjustments for inflation, the exemption amounts are now $11,580,000 per person (or a total of $23,160,000 for a married couple). These exemption amounts can be utilized by clients for lifetime gifts or upon the client's death to shelter assets from so-called "death taxes" in order to leave more assets death-tax-free to their families and beneficiaries. Currently, the estate and gift tax for amounts over this exemption (given during lifetime or at death) are subject to a top marginal 40% federal tax rate. For assets that clients leave to their grandchildren or that are left in a manner that "skips a generation" there is an additional generation-skipping tax of 40% (plus a generation-skipping tax exemption that applies to such transfers which is the same amount as the current Gift and Estate Tax Exemption of $11,580,000 per person).

Under current tax laws, these exemptions for both the federal estate and gift taxes and for the generation-skipping tax, are scheduled to revert to their prior 2018 levels in January 2026. This Gift and Estate Tax Exemption amount is currently the highest it has ever been in history. Clients need to be aware that after this upcoming November election, Congress may choose to enact tax legislation to have this Gift and Estate Tax Exemption amount revert to its prior levels (or an even lower amount) sooner than January 2026, and that estate and gift tax rates may be increased.

Furthermore, there have been discussions to eliminate the current step-up in income tax basis of assets at death under Section 1014. The step-up in tax basis rule has been a part of federal tax law since the inception of the U.S. income tax, although for a brief time period in the late 1970s there was a temporary carryover of an asset's income tax basis at death. A repeal of the step-up in income tax basis tax rule would effectively cause an income tax increase to those persons who inherit property at a family member's death.

Even if the current $11,580,000 Gift and Estate Tax Exemption is reduced by Congress in the future, gifts made prior to its reduction will still be recognized at death under current tax laws. In other words, the Treasury Regulations specifically state that there is no "clawback" of the previously used exemption when the donor dies, even if that donor has made gifts previously in excess of the Gift and Estate Tax Exemption amount in effect at that donor's death.

In addition to the Gift and Estate Tax Exemption, each individual in 2020 may gift $15,000 per calendar year to any number of donees without incurring a gift tax. Thus, under this annual gift tax exclusion, a married couple may gift up to $30,000 per year per donee, gift tax-free. Under current law this $15,000 amount increases for inflation. Additionally, amounts may be given gift tax-free for a donee's tuition and medical expenses.
Clients who want to take advantage of the current high Gift and Estate Tax Exemption amount and lower transfer tax rates should be proactive and take action now to transfer their wealth to lower family generations levels. Even though any federal tax legislation under a new Congress is likely not to be enacted until February or March 2021 at the earliest, Congress could make the effective date of such a tax change back to January 1, 2021. In addition, many estate planning transfers and planning techniques require valuation appraisals, and enough time may be needed to obtain such appraisals.

Conclusion.

Tuesday, November 3, 2020, and the subsequent days it may take to declare a winner, will potentially create significant changes to the tax laws often impacting high net worth individuals. While there is perhaps great uncertainty on whom will win, clients certainly need to be advised of the potential changes and be given an opportunity to enter into advanced estate planning transactions in a reasonable and time-appropriate manner. The need to reach out to clients is becoming more and more urgent, as time is running out of certain transactions if tax laws do change in 2021 and are retroactive to January 1, 2021.