Opportunities Under Tax Proposals

So What Does It Really Mean?

Recently, we ran through the high points of each candidate's tax proposals to do a side-by-side comparison of the two plans. While a comparison is an important starting point, it doesn't really tell us much about how those proposals might impact taxpayers and where opportunity might lie.

First, Income Taxes

Under the 2017 TCJA, the highest income tax bracket went from 39.6% to 37%, and while that was technically a reduction in income taxes, a 2.6% reduction is not a dramatic reduction, especially when state income taxes are factored in. Despite the modesty of this reduction, Former Vice President Biden is proposing that the highest income tax bracket be increased back up to 39%.

Given that there's a less than 3% swing in the highest income tax rate between the two candidates, I would say that a similar opportunity exists regardless of which candidate ends up in office. And it will mean that the highest earners will continue to be focused on planning techniques that can help them reduce their income tax burden.

Charitable giving techniques will continue to be a hot topic of conversation because charitable gifts result in an immediate reduction in income taxes. Those charitable gifts might be to split interest trusts such as charitable remainder trusts, gifts to private foundations, or the creation of donor advised funds that function like private foundations but generate deductions like public charities.

While reducing immediate income taxes is of great interest, techniques that reduce future income taxes are getting even more air time. Especially when that income tax reduction is coupled with creditor protection, living benefits, ready access to the funds and a self-completion feature. This, of course, is the use of cash-value oriented life insurance to provide tax-free income. The life insurance is purchased with after-tax dollars, but it grows income tax-free, can be accessed income tax-free and provides an income tax-free death benefit.

Combining charitable giving with a life insurance policy means that individuals will be able to reduce both the current income tax burden and future income taxes — regardless of which candidate ends up in office.

Now, Transfer Taxes

Most of President Trump's tax proposals consist of making the temporary changes from the 2017 TCJA permanent, and the transfer tax exemption is no different. Under the TCJA, the $5M (inflation adjusted) exemption was doubled to a $10M (inflation adjusted) exemption — but only until December 31, 2025. President Trump is proposing that this doubled exemption be made permanent.

Much of the estate and gift planning that's been done in the last three years has been focused on setting clients up for success, regardless of whether the exemption sunsets early, sunsets as currently scheduled or becomes permanent. This means that should President Trump's proposal become law, clients are in a good position to respond. They can make the gifts as planned or they can allow the transactions to continue, saving their transfer tax exemption to use in the future.

In addition, having a roughly $22M exemption per married couple doesn't mean that the couple will have the liquidity needed when assets are transferred or estate taxes are due. So coupling the increased exemption with the immediate liquidity of life insurance means that individuals will be able to implement their desired plan when the time comes.

On the other hand, Former Vice President Biden's transfer tax proposals are focused in a distinctly different direction from President Trump's. It will probably come as no surprise that Biden wants to accelerate the sunset and return to the pre-TCJA level of $5M per person (indexed for inflation). However, Biden has taken his transfer tax proposals one step further by proposing an elimination of the at-death basis step-up of IRC Section 1014.

Under current law, the basis of all assets in the decedent's estate is automatically increased to the fair market value of the asset, wiping out all capital gain in the asset. While the asset is still subject to an estate tax there isn't an additional capital gains tax applied, allowing the heirs to later dispose of the asset income tax-free. This is an enormously powerful provision of the tax code and much thought goes into "basis planning" in order to find ways to minimize the overall value of the taxable estate, while simultaneously maximizing the capital gain elimination through the basis step-up. Eliminating the basis step-up means that estates will need liquidity to pay estate taxes plus heirs inheriting these assets will need liquidity to pay the capital gains built into inherited assets.

Flexibility Is the Key

It is easy to get swept up in a presidential election, and even more so this year when we are having a presidential election in the midst of a global pandemic. But if these proposals illustrate anything, it's that this is just one moment in time, one presidential election, one opportunity to engage in long-term strategic planning. For us, it is important to understand the various tax proposals and to find the opportunities they represent, but it is just as important to focus on the future and to implement plans that set our clients up for success today and tomorrow.