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Business Signals – Tax Alert

An alert about the legal implications of issues affecting businesses and business owners in the Central Gulf Coast region.

Tax Alert: Impact of Federal Election Results on Tax Planning

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Tax lawyers have been waiting with bated breath for the results of the Georgia Senate runoff elections, which would effectively determine control of the U.S. Senate. Those results are now out, and it appears, barring any last minute challenges to the vote counts, that the Democrats have won both elections, which means that the Senate is now a 50/50 split between Democrats and their affiliated Independents and Republicans. This means, in practical terms, that the new Vice President, former Senator Kamala Harris, now holds the tie breaking vote. If the parties continue to vote along party lines as they have now done for many years, then the Democrats are fully in control of both the legislative and executive branches of government, at least for the next two years.

There is still much uncertainty as to what this result will mean in many areas of government, but one thing we do expect will be drastic changes in the tax laws of the United States. In 2017, President Trump and a Republican Congress passed sweeping changes to the tax code, with very little support from Democrats and which the Democrats have criticized since its enactment. New President Biden's campaign platform clearly shows that the Democrats will place a priority on reversing many of these tax laws, and adding many more of their own.

This tax alert is intended as a short summary of the expected tax proposals by the Biden administration, and also contains a few tax pointers that should be considered by taxpayers in the upcoming year, especially owners of smaller businesses.

I. Biden Tax Proposals

Based on the campaign proposals, we can expect that new President Biden and the Democratic Congress will at least propose the following major changes to the Internal Revenue Code:

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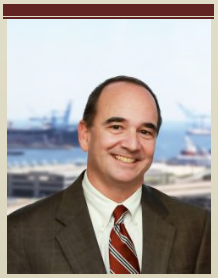

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Corporate Taxation

- Increase in corporate tax rate—from 21% to 28%;
- Minimum tax on corporate income--minimum 15% tax rate on income reported on financial statements (so-called "book income") of corporations with at least $100 million of book income;
- New Fee in financial institutions—unstated at this time;
- New taxes on fossil fuel industry and pharmaceutical industry;
- Increase of penalties for worker classification issues;

Individual Taxation

- Increased marginal tax rate for top-earners—39.6% for earners over $400,000;
- Social Security tax reinstituted on income over $400,000 (taxpayers in between $137,700 and $400,000 still don't pay the tax)
- Capital gains tax rate re-characterized to ordinary income tax rates for taxpayers over $1 million;
- Elimination of Section 1031 like-kind exchange rules and other real estate tax deductions;
- Expansion of availability of various tax credits, including child care tax credit, Earned Income Tax Credit, New Markets Tax Credit, certain environmental credits and others.
- Phase out of new QBI Deduction for taxpayers earning more than $400,000 (used to be unlimited except for specified trades or businesses)
- Capping itemized deductions at 28%;
- Create special rule to make forgiven education loans non-recognizable as income.

Foreign Taxation

- Double the tax rate on global intangible low-taxed income (GILTI), from 10.5% to 21%, and eliminate the exemption for qualified business asset investment (QBAI). Computation of GILTI will be on a country by country basis, instead of worldwide;
- Made in America Tax credit—up to 10% of U.S. investments geared toward creation of jobs in the U.S. Would be immediately redeemable (don't have to wait on filing tax return);
- New surtax on foreign produced goods consumed in the U.S. and services conducted outside the U.S. Anticipated to apply only to U.S. parent companies, so not technically a tariff.

Estate and Gift Taxation

- Anticipated to lower exemption levels to half current levels ($5.85 million per person);
- Elimination of the step up in basis rules for decedents.

II. Income Tax Planning

Based on the proposals by President Biden, we would recommend that individuals and businesses at least begin consideration of the following as part of their 2021 tax planning:

a. Review your Compensation Structures:

There are major tax provisions in President Biden's proposals for taxpayers earning over $400,000. This includes a higher tax bracket of 39.6 percent; a reinstituted social security tax for all income over 400,000; and a phase out of the new qualified business income deduction for owners of pass-through entities. Accordingly, taxpayers will now be penalized for earning more than $400,000 per year, and for those taxpayers who are close to that number, it may be beneficial to reduce your compensation below that threshold, in order to avoid those new tax provisions.

b. Maximizing Deductions

Obviously, deductions are the key factor in lowering taxable income for both individuals and corporations. As far as we can tell, there are no additional deductions in President Biden's platform, but there will be a cap on itemized deductions of up to 28 percent for upper-income individuals, which again we suspect would be for taxpayers earning more than $400,000.

For corporations, it will be very important to maximize deductions in order to lower overall corporate income, which will now be subject to a much higher tax rate (28% instead of 21%). One other item of note for all taxpayers is that most tax lawyers expect that the $10,000 limitation on state and local tax deductions which actually be eliminated (thus making it unlimited subject to certain itemized deduction thresholds and limitations), which should help most taxpayers.

c. Review Availability of Potential Tax Credits

Tax credits are powerful tools for lowering tax burdens, because they are a $1 for $1 reduction of the tax itself, rather than a reduction of taxable income. We expect that there will be many new tax credits passed by the democratic Congress in the upcoming year. This includes a potential "Made in America" tax credit for jobs created in the United States. There will also be many new "Green Energy" tax credits that are expected to pass. All taxpayers should pay attention to these credits and, where appropriate, structure their transactions to take advantage of them.

d. Special Issues for Real Estate

There are going to be many tax changes in the area of real estate with the Biden administration. Perhaps most importantly, we expect that the Democratic Congress will move to completely eliminate 1031 exchanges from the Code, which takes away one of the main tools of tax deferral for real estate investors. We expect that Democratic legislation will also eliminate various tax breaks relating to real estate, including faster depreciation rules; elimination of the QBI deduction for rental real estate activities; changes to the passive loss rules, and many others.

It is also expected that the capital gains tax rate will be converted to ordinary income for any taxpayers with taxable income over $1 million dollars. Accordingly, if you have any real estate transactions pending, you should consider accelerating those transactions to take advantage of the current tax laws. This of course assumes that the Congress will not make the tax changes retroactive, which is also something all taxpayers should pay attention to in the upcoming months.

e. C Corporations

Perhaps the largest tax burden of the Biden tax plans will be felt by larger companies and C corporations. As a starter, all C corporations need to be aware that President Biden expects to propose a new 28 percent corporate tax rate, which is a major increase from the 21% corporate tax rate that was put in place by President Trump's tax reform package. This increase, along with a potential increase of taxes on dividends (which could rise to ordinary income tax rates), could significantly impact the overall tax burden of C Corporations, meaning that choosing what kind of entity you would like to use (C Corp, S Corp, partnership, etc..) could become very important.

All larger C Corporations need to be aware of the possibility of passage of a new minimum tax on corporate income. President Biden is expected to propose a minimum 15% tax on companies with at least $100 million dollars in book revenue, which effectively will ignore most of the typical deductions taken by C corps. It is expected that these tax changes alone will generate well over a trillion dollars in additional tax revenue over the next 10 years.

f. Oil and Gas Industry

If you own a business in the oil and gas industry, you need to be aware that President Biden is proposing major changes to deductions in that area, including the potential elimination of the deductions for drilling costs and depletion. While the oil and gas industry will most likely suffer a major tax hit, all taxpayers should at least factor in the increase in oil and gas prices as a result of these new changes. Simply put, it is likely that prices for oil and gas will rise significantly over the next year once these changes have been enacted, in order to cover the additional costs.

III. Estate and Gift Tax Planning

We also expect major changes in the area of Estate and Gift Taxation, which has been a relatively stable area for many years and which, due to the higher exemption amount (currently $11.7 million per person), has not been a major concern for most taxpayers. Based on the proposals by President Biden, we would recommend that individuals begin reviewing their estate and gift tax plans to determine if any action should be taken:

a. Concerns

1. Biden's tax proposals include lowering the applicable estate and gift tax exclusion amount. The current exclusion amount is $11.7 million per person and we expect that the exclusion amount will be significantly lowered in the upcoming administration. President Biden's current proposal is to lower the amount to half of the current amount ($5.85 million), but once that legislation is introduced it is possible that Congress could decide to lower it even further, perhaps as low as $3 million per person. This is a significant change and should not be ignored, especially if the value of your estate is near or over $3 million.

2. The other major change proposed is the elimination of the step-up in basis of property upon the death of the owner of such property. The step-up basis was a powerful tool for estate planners, essentially raising the tax basis (which is the number used in calculating capital gains taxes) to fair market value upon death, meaning that if the Estate sold the property after death for FMW there would be no capital gains taxes incurred.

b. Planning Ideas and Tools

1. If your net worth is greater than $5 million then you need to consider an estate plan that establishes a credit shelter trust upon the first to die of you and your spouse. If you are anywhere near the $5 million threshold but not above this you need to consider an estate plan that provides for the surviving spouse to be able to disclaim part of his or her inheritance and place the amount disclaimed in a credit shelter trust for the benefit of the surviving spouse.

2. Take immediate advantage of the current $11.7 million exclusion through immediate transfers of interest in property. Of course, this assumes that any new legislation is not made retroactive to January 1, 2021. In particular, taxpayers who own businesses should see their financial advisors immediately to begin planning for potential transfers of interests, as it will be very difficult to obtain a formal business valuation (which is necessary for the planning) once the tax legislation has been introduced.

3. If it is inevitable that upon your death or the second to die of you and your spouse that your estate will owe estate and gift taxes, then you need to make sure there is enough liquidity in your estate to pay those estate taxes. One way to take care of that is through the establishment of an Irrevocable Life Insurance Trust, which if done properly will not be counted in the value of your estate at your death but will be available to your estate to provide funds for payment of taxes.

4. Lastly, consider transfers of low basis properties to heirs, or selling such properties to third parties and reinvesting the funds in new properties. If you no longer need these assets and plan on transferring them to heirs upon your death, then transferring them now may help save taxes.

IV. Conclusion

The election results in Georgia have caused great uncertainty in the area of tax law, and we do not yet know exactly what will happen. However, it is not too late (or too early) to make certain changes to minimize or avoid these higher taxes, so we would recommend that all taxpayers with moderate to significant estates set up an appointment with their respective financial advisors to discuss their options.

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