Georgia on My Mind

2020 has been a challenging year, replete with uncertainty in many aspects of our lives. All of us have been impacted in some way by COVID-19-related health concerns, economic shutdowns, and volatility in financial markets. The uncertainty continues as we await two Senate runoff elections next month, which will determine if the Democrats gain full control of the federal government for the first time in 11 years. If that happens, we could see meaningful changes to federal income and estate taxes in the near future.

President-elect Joe Biden's tax plan seeks to raise the top income tax rate for corporations from 21% to 28% and raise taxes on foreign income. Proposed changes for individuals include raising the top tax rate from 37% to 39.6% and imposing the 12.4% Social Security payroll tax on wages above $400,000. Biden also seeks to tax capital gains at ordinary income rates for taxpayers with income in excess of $1 million. That means the highest earners would be subject to a capital gains tax of 39.6% versus the preferential rate of 23.8% currently in effect. Not all of Biden's proposals are tax increases; he does support repealing the $10,000 cap on state and local tax deductions. For high-income taxpayers in states such as New York and California, this would be a welcome change. Biden has also proposed new tax credits for childcare, health insurance, elderly care, and home ownership.

One of the most significant changes proposed by Biden that will impact intergenerational wealth transfer is the repeal of the free step-up in basis. The step-up is a readjustment of the value of appreciated assets passed on to heirs following one's death. Typically, inherited assets have a higher market value than when the original owner acquired them. For some individuals, this unrealized gain can be a significant part of their estate due to long-held legacy positions where liquidating during lifetime would have resulted in a significant tax liability. Under current rules, the cost basis of inherited assets is stepped-up to the fair market value on the date of death, which minimizes the tax liability passed on to heirs. If the step-up rule is repealed, the estate of individuals who die with appreciated assets will pay income taxes on the unrealized gains at the time of death, decreasing the amount of wealth transferred to heirs. Here is an example of how the step-up in basis works:

A woman purchases stocks in her individual brokerage account at a cost of $100,000. She chooses to hold the stock for the long-term and watches the fair market value grow to $1,000,000. She's reluctant to sell the stocks, knowing a sale would result in her recognizing $900,000 of capital gains, the price increase of the stock over the original cost of $100,000. Given her high income levels, those gains would be taxed at the maximum federal capital gains rate of 20% plus an additional 3.8% of net investment income tax. Selling during her lifetime would result in a tax bill of $214,200, which could be greater if she lives in a state that imposes its own capital gains tax.

She instead holds the stock and at her death, it passes to her daughter. The cost basis of the stock gets stepped-up at death, meaning her daughter now owns $1,000,000 of stock

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with an adjusted basis of $1,000,000. If the daughter were to immediately sell the stock, she wouldn't recognize any capital gains on the sale. Even if she were to hold the stock, her capital gains tax exposure would be limited to appreciation in excess of $1,000,000. Under Biden's proposal, the $900,000 of capital gains would be taxed at the mother's death, decreasing the amount of wealth transferred to her daughter by over $200,000.

The current home-sellers' exclusion of $250,000 of gain per individual, or $500,000 for a couple, is likely to remain in effect.

Plan Seeks to Lower Lifetime Federal Exclusion Amounts

The Tax Cuts and Jobs Act of 2017 (TCJA) effectively doubled the lifetime federal exclusion amounts individuals were able to shelter from transfer taxes. Indexed for inflation, the current lifetime exclusion amount is $11.58 million. This means that a married couple can gift a combined $23.16 million without ever having to pay a tax on it although it would leave them with no estate tax exemption.

Given these extraordinarily high amounts, it's estimated that less than .01% of the 2.8 million people expected to die this year will be subject to a federal estate tax. The TCJA exemptions are set to expire at the end of 2025, reverting to about $5 million per person, but they could expire sooner. The Biden plan seeks to lower the federal estate exclusion to $3.5 million per person and the generation-skipping tax (GST) exclusion to $1 million — levels not seen since 2009. His plan also seeks to raise the maximum federal estate tax rate to 45% from the current 40%.[1]

Irrevocable Gifts Reduce Taxable Estate, but Limit Flexibility

Given the uncertainty of a Congressional majority mentioned earlier, it may be difficult for individuals who have not already taken advantage of their maximum lifetime exemptions to decide whether to take any action in the near term. Sheltering assets from transfer taxes means you remove the assets from your taxable estate via an irrevocable gift (meaning you give up the right to access those assets in the future). In considering one's options, facts and circumstances matter. For example, it's easy to recommend someone to gift $11.58 million now if their estate is valued in excess of $20 million, but for individuals with lesser estates, gifting the majority of one's assets to avoid an uncertain future estate tax increase may be a less sensible option. Individuals should use their lifetime exemption prudently to avoid a situation where they have gifted away too much of their wealth and can no longer support their lifestyle.

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Gifts Offer More Control Over Transferring Wealth (With Certain Asset Limitations)

For individuals who do not want to execute an irrevocable gift of their wealth, but want to mitigate their estate tax exposure, gifting strategies provide an alternative way to reduce their taxable estate over their lifetimes.

- **Annual Exclusion Gifts** — Each individual can gift $15,000 per year to an unlimited number of recipients, tax-free. For married couples, the gift amount per person doubles to $30,000 provided an election is made to split the gift on a federal gift tax return. Gift can be made in-kind with securities, or with cash.

- **529 Plan Funding** — Individuals can contribute to a 529 plan for any family or non-family beneficiary using their annual exclusion availability. 529 plans offer the unique opportunity to forward-fund a plan with five years of funding

($75,000 single, $150,000 married) in one year. This allows for a greater reduction in a taxable estate and gives the 529 a jump on appreciation potential.

- **Tuition and Medical Exclusion** — Payments made directly to an educational organization for tuition and payments made directly to a provider for medical expenses are not treated as taxable gifts. There is no limit on the amount of these tax-free gifts you can make to any qualified school, college, or university.

- **Charitable Gifts of Appreciated Securities —** Using appreciated securities to satisfy a charitable gift removes not only the asset value from the donor's estate, but also the embedded gain which would be subject to capital gains tax if sold. If large enough, a charitable security donation could enable a taxpayer to itemize deductions, reducing their overall taxable income. This strategy can also benefit one's overall portfolio diversification, as many investors hold on to legacy position with high embedded gains solely to avoid the tax liability, to the potential detriment of portfolio allocation and performance.

It bears repeating that there is no guarantee that President-elect Biden's tax proposals will be enacted in his first year in office. All eyes now look to Georgia, where the January 2021 runoff election could either solidify Republican control in the Senate, or potentially give Democrats a 50-50 majority there (with Vice President-elect Kamala Harris casting tie-breaking votes as Senate President). If the Democrats prevail and regain control of Congress, it is likely that some of Biden's proposals could come to fruition, but income tax changes are not done retroactively, so should not apply in 2021. This leaves ample time for tax planning in 2021. Estate tax changes could be tied to the effective date of a bill, so we'll be watching carefully. Although we are circumspect when it comes to making any predictions about what could happen in Washington, it would appear that the lack of big, decisive wins in the Senate and the House in November could diminish the feasibility of major, sweeping policy changes taking hold.

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Please contact me or your wealth advisor to discuss how the evolving tax landscape could impact your financial situation and estate planning needs. We are always happy to facilitate a discussion with your legal and tax professionals along these lines.

[1] Source: Tax Policy Center. www.taxpolicycenter.org/briefing-book/how-many-people-pay-estate-tax

Disclosure

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