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Election Year Tax Planning

"We can't control the wind, but we can adjust our sails."

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The 2020 presidential election is now less than two months away, and the outcome remains patently unclear. The twin news cycles of COVID and, more recently, social unrest continue to tug at public sentiment in both directions. The situation remains fluid, and as we recently experienced in 2016, two months is a lifetime in politics.

The Democratic Party platform contains a multitude of substantial revenue raising proposals, both with respect to income as well as estate and gift taxes. A Republican victory would point to a continuation of the status quo … and perhaps even further tax relief. The stakes in November couldn't be higher.

Since the beginning of the year, we have been fielding election-related tax questions on a daily basis from high-net-worth individuals, family offices, businesses, and investors across our broad universe of clients. Regardless of where they sit on the political spectrum, or whether for or against tax increases, their inquiries are often similar … what should they be doing now in light of their respective financial circumstances? Our response to all has remained consistent: be *aware* and *prepare.*

"Be *aware* and *prepare*" simply means that taxpayers should be *aware* of potential legislative tax changes on the horizon, and then *prepare* for implementation of appropriate strategies as events unfold and clarity emerges. Such measures are often irrevocable, however, and consequently we continue to caution against premature actions based upon fluctuating predictions of the electoral outcome. There should be plenty of time to take evasive action in the event of a "regime change."

But before turning to the specific tax proposals currently being discussed by the Democratic Party, two topics should be addressed, both of which can impact the decision of what to do and when to do it. They are the possibility of tax legislation being made retroactive, as well as the tax implications of the election outcome in the Senate.

Retroactivity of Tax Legislation

Federal *agency rulemaking* cannot be applied retroactively, including federal tax regulations promulgated by the Treasury. [And of course Congress is barred from passing ex post facto laws or bills of attainder … meaning legislation which either i) renders an act illegal after its commission, or ii) levies criminal punishment without trial.]

However, there is no statutory or constitutional bar to tax legislation being retroactive, and the courts have continually deferred to Congress and state legislators in this regard. As long as the constitutional protection of due process is not violated, tax legislation can reach back in time.

Violating due process can manifest in two ways: duration or severity. Retroactivity of 12 months or less, or not beyond the period during which the legislation itself was pending before Congress, has specifically been held to not violate due process and is, therefore, permitted.

Why is this important? Because if a taxpayer delays action until after clarity in November, there is always the possibility that tax legislation could be made retroactive back to the date of the election and thus thwart tax planning undertaken immediately thereafter. The counterpoint to this possibility is that although retroactivity is not barred, it is atypical. And if future tax legislation were to be made retroactive, some

commentators believe it would not reach back beyond January 2021 when the new administration took office as opposed to before the election itself.

Each taxpayer must weigh the risk of acting prior to the election and potentially "picking the wrong horse," against the risk of waiting until immediately after the results and possibly falling victim to retroactivity.

The Senate Outcome

Some commentators have opined that even in the event of a "blue wave" Democratic sweep in November, meaning capturing the presidency in addition to both houses of Congress, the possibility of a 60 vote majority in the Senate is remote. With a minimum of 41 votes, the thinking is that the Republican minority would remain "filibuster proof," acting as a firewall against tax legislation that the Republicans found objectionable.

However, this line of reasoning would appear questionable in light of the fact that the Democrats have openly discussed eliminating the filibuster altogether if they were to gain a Senate majority. Since the filibuster is procedural in nature, it only requires a majority vote for its elimination, which includes a vote by the vice president in the event of a tie. So if the Democrats were to capture the presidency while gaining only three Senate seats to reach that tie, the likelihood of significant tax increases in the near future rises exponentially.

The Specific Proposals

Let's now proceed to highlight what we believe are the most significant tax proposals currently being discussed by the Democratic Party, along with certain potential tax planning responses and relevant observations.

Income Tax Proposals

Significant proposals being discussed include:

- Raise individual top marginal tax rate from 37% back to 39.6% on incomes above $400,000.
- Raise corporate tax rate from 21% to 28%, plus a potential 15% minimum tax over certain thresholds.
- Raise tax rate on capital gains to 39.6% for taxable incomes over $1 million.
- Extend 12.4% payroll tax to all earned income over $400,000, retain the tax on income up to $137,700.
- Cap itemized deductions at 28% and restore the Pease limitation on income over $400,000.
- Repeal the remaining §1031 Exchange provisions currently benefiting real estate.
- Restore the deduction for state and local income taxes.

Possible planning responses: Acceleration of income recognition into 2020. Approaches include:

- Exercising outstanding stock options or other deferred compensation rights.
- Converting traditional IRA into a Roth.
- Prepaying compensation, declare dividends.
- Foregoing installment sale treatment or 1031 exchange benefits.
- Delay otherwise deductible expenses until following year.

Observations:

Accelerating the recognition of taxable income is certainly strong medicine, and should be weighed carefully against various unknowns, including the possibility of tax changes reverting back in the future.

On another note, we are already seeing the potential for increases in the corporate tax rate affecting choice-of-entity decisions.

Estate and Gift Tax Proposals

Proposals being discussed are:

- Reduce individual transfer tax exemption from $11.16 million back to $3.5 million.
- Reduce combined marital transfer tax exemption from $23.16 million to $7 million.
- Eliminate step-up in tax basis of assets owned at date of death.
- Eliminate valuation discounts in transferring equity interests to family members.

Possible planning responses:

- Transferring assets in order to exhaust the available $23.16 million exemption by gifting.
- Focusing on gifting as opposed to holding assets in anticipation of an eventual step-up in tax basis.
- Considering asset transfer strategies which rely on valuation discounts, e.g., family limited partnerships.

Observations:

Taxpayers have expressed concern that if they exhaust their transfer tax exemption now, and that exemption level is subsequently lowered and made retroactive, they could be assessed a significant gift tax liability on the excess amount. Although possible, such action by Congress would certainty test the limits of due process as previously discussed.

Repeal of Tax Cuts and Jobs Act (TCJA) Components Seen Benefiting High Income Taxpayers

With respect to the TCJA, the following is being discussed:

- Eliminate the 20% “small business deduction” (§199A), for real estate or where taxable income exceeds $400,000.
- Reduce or eliminate benefits under the Opportunity Zone Program.
- Double the tax on certain U.S.-owned foreign corporations from 10.5% to 21%. (GILTI regime.)

Possible planning responses:

- Reconsidering prior and future choice-of-entity determinations in light of elimination of 20% deduction.
- Engaging in an “inclusion event” to accelerate otherwise deferred Opportunity Zone capital gains.

Observations:

There is currently bipartisan support in some measure for both the Opportunity Zone (OZ) program, as well as the 20% small business deduction. The Opportunity Zone program is meant to benefit economically disadvantaged areas, and some 95% of “mom and pop” businesses in the U.S. are structured as partnerships or LLCs. Eliminating either or both could be a tough vote to cast for certain Democratic congressmen.

Implementation of a Wealth Tax

A federal tax on wealth is currently being discussed openly in economic circles. It is seen by some as a more direct means of addressing wealth inequality in the U.S., and Senators Elizabeth Warren and Bernie Sanders strongly advocated for its enactment during the Democratic primary. They now act as close economic advisors to the Biden campaign, and Warren’s name has in fact been raised as a possible Secretary of the Treasury in the event of a Biden presidency.

Possible planning responses are difficult to assess without particulars as to target asset classes and valuation methodologies.

Observations:

Wealth taxes have been tried before, albeit outside of the U.S. and with limited success stemming from valuation and enforcement issues. France is a notable example. But we add that there is a wealth tax bill currently working its way through the California legislature which would levy a zero point four percent (0.4%) annual tax on aggregate net worth above $30 million, inclusive of all asset classes. Commentators describe its odds of passage as moderate to good.

Conclusion

Regardless of one's politics in general or view on tax increases in particular, the upcoming November election stands to have major consequences for overall tax policy as well as the economy at large. Prudence would dictate that taxpayers review their current financial picture, along with their service providers, to avoid being blind-sided by tax legislation potentially on the horizon.

It may just be time to adjust those sails.

Contact Us

As always, for further guidance and assistance, please reach out to your PKF O'Connor Davies tax engagement team members, or to Thomas J. Riggs, JD, CPA, MAS, Partner, Director Financial Services Tax & Advisory at triggs@pkfod.com. We are here to help.

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