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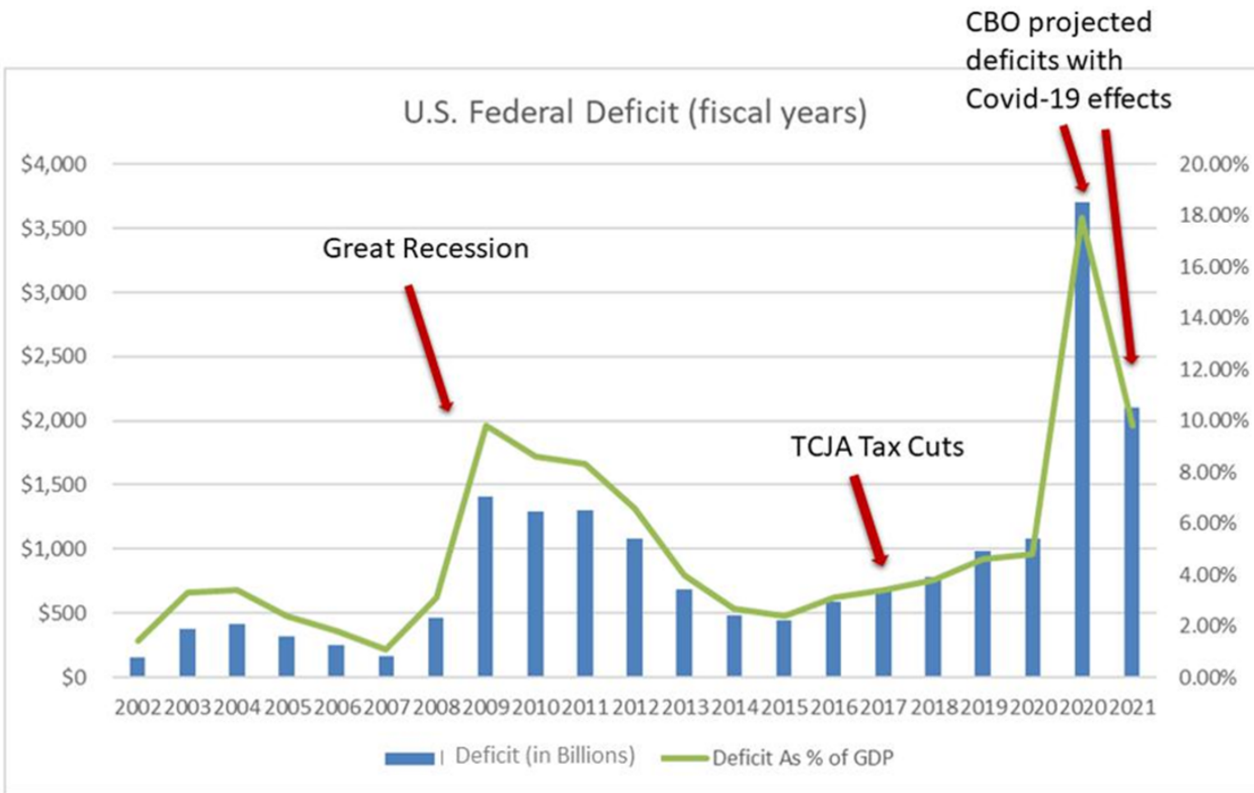
Higher Taxes Are Coming – Hereâ€™s How to Prepare

We are all dealing with greater uncertainty than usual driven by questions like: How long will we be battling Covid-19? What will the economic impact be? How will the stock market perform? And will my kids ever go back to school?

Another worry that might not be on everyoneâ€™s radar is the likely increase in taxes that could occur as early as next year. But, unlike whether we will find a Covid vaccine or worrying about the stock market, this is an issue we have some control over. With some planning, we can take steps to mitigate the effects of future tax increases.

I raise this issue because itâ€™s likely that taxes will rise if thereâ€™s a â€œblue waveâ€• in which the Democrats win the presidency, House and Senate in November. However, even if there is no blue wave, given the state of our countryâ€™s finances, there is a very real possibility that taxes will increase â€“ particularly for the wealthy â€“ no matter which party prevails in November.

Because of the pandemic, the federal government is running higher deficits as a percentage of GDP than weâ€™ve seen since World War II. Even before the pandemic, the government deficit was nearly $1 trillion a year. This fiscal year, the Congressional Budget Office projects the deficit will nearly quadruple to $3.7 trillion. At some point, regardless of which political party is in power, the U.S. government will need to raise revenue to stem the tide of red ink. As Steinâ€™s Law states: â€œthat which cannot go on forever must stop.â€•



Source: St. Louis Trust & Family Office, Data via The Balance

Bidenâ€™s Proposed Tax Increases

Joe Bidenâ€™s tax plan would reduce the after-tax income of the top 1 percent of taxpayers by 7.8%, according to the Tax Foundation. His proposed changes include raising income tax rates and social security taxes for individuals earning more than $400,000 per year, capping itemized deductions at 28% of value (compared to no cap now), and taxing long-term capital gains and qualified dividends at ordinary rates for those with income above $1 million (compared to top rates of 20% now).

Bidenâ€™s plan would also increase taxes on the assets we pass to our descendants. Under current law, beneficiaries receive assets that pass through a decedentâ€™s estate with a basis equal to the value of those assets on the date of that personâ€™s death; this is called a â€œbasis step-up.â€• Biden has proposed doing away with this stepped-up basis at death, which means that beneficiaries would inherit assets with built-in gains compared to receiving the assets with no built-in gain under current law.

Heâ€™s also expected to propose reducing the $11.58 million gift, estate, and generation-skipping transfer tax exemptions down to the $3.5 million to $5 million range they were before 2017â€™s Tax

Cut and Jobs Act.

However, itâ€™s important to keep in mind that what candidates propose while campaigning often differs from what they actually do in office. For example, when the Bush tax cuts were expiring at the end of 2010, everyone expected the estate tax exemption to return to $1 million, down from $3.5 million in 2009. But much to everyoneâ€™s surprise, President Obama and Senate Majority Leader Mitch McConnell reached an agreement to raise the exemption amounts to $5 million. It is rumored that Obama assented to this proposal in return for McConnell agreeing to push through the ratification of the START treaty that Obama had negotiated with Russia.

Given these variables, itâ€™s probably best to wait and see how the election turns out before taking any action. However, you can start to contemplate the following estate planning and income tax strategies, which can help you mitigate future tax increases if and when tax laws change.

Estate Planning Strategies

1. **Plan to gift exemption amounts.** A Democrat-controlled government would likely reduce the current $11.58 million gift tax, estate tax, and GST exemptions. If youâ€™re a taxpayer who is wealthy enough to do so, you should consider gifting whatever you have left of that exemption before the effective date of the new tax. This requires identifying what assets you would gift, who you would gift them to, and whether it makes sense to set up trusts for those recipients or fund an entity like an LLC as a conduit for the gifts.
2. **Take gains before your death.** If basis step-up at death is repealed, you might want to pay taxes on the appreciation of the assets in your estate before your death. That will reset the tax basis for your beneficiaries, and the income taxes you pay will reduce the value of your estate, resulting in estate tax savings. If you do this before the tax law changes, you can pay taxes on those assets at todayâ€™s lower rates.

Income Tax Strategies

Three categories of strategies can help reduce your income taxes if rates increase: accelerating income recognition before rates rise, deferring deductions, and structuring your investments to minimize taxes.

1. Accelerate income recognition. If your tax rate is set to rise after a new tax law, you could intentionally recognize income before the effective date of the new tax law so that youâ€™re taxed on that income at the current lower rate. You can achieve that by:

- **Converting your traditional IRAs into Roth IRAs.** Distributions from a traditional IRA are taxed as regular income, while distributions from Roth IRAs are tax-free. When you convert a traditional IRA to a Roth IRA, you will be subject to taxes at ordinary rates in the year you convert it. So, if you do the conversion now, you can pay taxes on the IRA at todayâ€™s lower rates. Then when tax rates rise in the future, you can take distributions from your Roth IRA tax-free, avoiding the higher rates.

- **Selling appreciated assets now to fund your future spending needs.** By selling appreciated assets in your portfolio at todayâ€™s lower tax rates, you will avoid paying higher taxes later when you need to raise cash. You can even re-buy the assets you sell, which resets their basis. For example, if you withdraw $100,000 per year from your portfolio, and you have over $1 million of highly appreciated Amazon stock, it could make sense to sell $500,000 of the Amazon stock to fund your portfolio withdrawals for the next five years. If you are worried about being out of the market, you can re-buy the Amazon stock or other investments at todayâ€™s prices. That way, the tax on the appreciation of that stock will be lower when you sell it later to fund your living expenses.
- **Intentionally taking gains in your irrevocable grantor trusts.** With an irrevocable grantor trust, only the creator is subject to paying taxes on the trust, and usually such trusts are not considered part of his or her estate. Because these trusts do not get a stepped-up basis at death, paying taxes on any gains at todayâ€™s lower rates will reduce the trustâ€™s tax liability when it becomes non-grantor (meaning that the trust begins to pay its own income taxes – often at the creatorâ€™s death). This is good estate planning for two reasons: because the income taxes paid by the trust creator will reduce the assets in his or her taxable estate at death, and the trust will have a lower future tax burden because of its increased basis.
- **Opting not to defer income into your deferred compensation plan.** If you are an executive or on the board of a company and participate in a deferred compensation plan, you can choose not to defer your 2020 or 2021 income. This would enable you to pay taxes on the income at the current lower rates. Likewise, if you have compensation such as restricted stock that is eligible for an 83(b) election, it may make sense to make that election now before a tax rate increase.

2. Defer deductions. Given the time value of money, it typically makes sense to take deductions sooner rather than later. However, if you know that taxes will rise, it may be beneficial to defer deductions until higher tax rate years. For example, charitable deductions are easy to defer. You would just give less this year and make it up in future years. Or you could pledge to make future gifts to charities and fund those gifts during higher tax years. However, this planning strategy would only make sense if thereâ€™s no 28% cap on deductions. If you own closely-held businesses, you could decide not to elect accelerated expensing and depreciation, and push those deductions into future years.

3. Structure your investments to reduce taxes. Itâ€™s always a good idea to pay attention to the tax drag of your investments, but it will be even more critical under a higher tax regime. You can reduce the taxes on your investment portfolio by:

- **Using lower tax realizing investments** such as index funds or investment managers that are tax-sensitive or have low turnover and thus have a lower tax drag. For example, tax-managed index accounts are separate accounts that track an index (whether cap-weighted or factor tilted) on a pre-tax basis but generate losses post-tax. Tax managed index funds typically generate capital losses each year (even while keeping up with the market on a pre-tax basis) that you can use to offset gains elsewhere in the portfolio. So, tax-managed index accounts can enhance the tax efficiency of a portfolio.

- **Investing inside life insurance policies.** Investments inside life insurance contracts grow without tax, and the death benefit is tax-free as well. Also, you can usually make withdrawals without tax consequences. A lower-cost option for large policies is Private Placement Life Insurance. PPLI are custom separate account products that have lower fees than traditional life insurance and much greater investment flexibility. Putting some of your investment portfolio inside PPLI can save significant taxes.

Moving Forward

When devising tax planning strategies for clients, I often think of a quote from an opinion written by U.S. Court of Appeals Judge Learned Hand in 1934: â€œAnyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase oneâ€™s taxes.â€•

I wholeheartedly agree with Judge Hand that within the confines of the law, itâ€™s entirely appropriate to organize your financial life to reduce your tax burden. Because everyoneâ€™s situation is different, the planning strategies Iâ€™ve proposed may be great for one taxpayer and not so great for another. Thatâ€™s why itâ€™s critical to consult your financial and tax planning advisors to determine whatâ€™s right for you.

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