JUNE 2021 NEWSLETTER

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PREPARING FOR PRESIDENT BIDEN'S TAX PLAN

1. BLOGS:

1. The following are a few of the business, tax, employment, estate planning and business litigation blogs posted on our main website www.pozzuolo.com during the past month:

   a. No Poaching-No Hire Agreement Between Companies Ruled Unenforceable;

   b. The Best Way To Transfer A Business Within Family; and,

   c. Family Business And Your Estate.

Please visit our website www.pozzuolo.com for more information on these and other relevant business, tax, estate, business litigation and employment topics.

PREPARING FOR PRESIDENT BIDEN'S TAX PLAN

The next phase of President Biden's economic agenda is his proposed new tax plan targeted towards the top 1% high earners in hopes of raising $1.5+ trillion in extra tax revenue over the next decade. This has created a lot of anxiety and concern for wealthy individuals, families and private business owners over what are the potential changes, how will it affect them, and what they can do to

plan against these proposed changes.

The two major changes wealthy and high earner clients are worried about are the possible retroactive application of capital gains being taxed at an elevated ordinary income tax rate of 39.6% (i.e. 40% will be used for simplification purposes) for individuals earning more than $1 MM a year instead of the current 20% tax rate, and the second being the potential removal of the fair market value step-up in basis of assets held at death and possibly an outright capital gain tax on the unrealized appreciated value of unsold assets held by the decedent at his/her death instead of the current step-up in basis.

The above first concern is that for individuals earning over $1 MM a year, capital gains taxes would be increased to a maximum rate of 39.6% (the ordinary income rate – again for calculations we use 40% for simplicity) instead of the current 20% (plus possibly subject to the Net Investment Income Tax of 3.8%). This doubles capital gains tax rates for wealthy and high earner individuals.

This may even lead to unfair or inequitable results for the middle class upon the sale of his/her privately owned business. Even if the middle class taxpayer earns substantially less than $1 MM a year as a private business owner, he/she may sell the business at retirement after 25 to 40 years of ownership in excess of $1 MM. For example, if the private business owner earned between $100,000 to $200,000 per year for the past 10 years and sold the business for $3 MM he/she may be facing a $1.2 MM Biden proposed tax bill instead of $600k under the current tax legislation despite the $3 MM really representing the value of his/her future income streams. There will be a difference of closing with $1.8 MM versus $2.4 MM not including transaction costs, fees and expenses which will tremendously affects his/her retirement. Despite wealthy or high earner individuals scrambling to lock-in tax savings, this proposed capital gains tax rule is proposed to be effective as of the end of April 2021, so an immediate sale may not enable a business owner to circumvent this proposed tax legislation absent further planning.

The second is that the step up in basis at death may be removed and replaced with a $1 MM step up limit for individuals ($2 MM for married couples). In addition, under the Biden's proposal there may even be a tax on all unrealized capital gains on appreciated, unsold assets held by a decedent over this $1 MM ($2 MM for married couples) limit at death. Usually upon death, the basis in the decedent's property is adjusted up or down to the fair market value at death. This means if an individual started a company with $500k and it was worth $20 MM at the person's death, there is an unrealized gain of $19.5 MM. Under the current rules, there is a Federal Estate Tax on the $20 MM, but the unrealized gain is wiped away at death. This means there is a 40% Federal Estate tax on the $20 MM which would result in an $8 MM tax, absent the Federal Unified Credit. However, if the business was sold immediately after death for $20 MM, there would be no recognizable gain or loss on the sale.

Under President Biden's proposed tax legislation, a tax would be recognized on the $17.5 MM ($19.5 MM less the proposed $2 MM Federal Estate Tax exemption for married couples) unrealized gain at death, and then Estate Tax would be charged on the remainder. Additionally, the gain would be recognized at the higher 39.6% ordinary income rate (again 40% is used for simplicity) since the gain is over $1 MM. This means there would be an immediate capital gains tax of about $7 MM, plus, absent the Unified Credit, a 40% Estate Tax of $5.2 MM on the remainder for a total tax of $12.2 MM. That is an extra $4.2 MM of taxes at death under Biden's proposal.

Some other notable changes proposed or that have been discussed are: i) the increase of the higher marginal income tax rate to 39.6% (implied in the capital gain calculations); ii) lowering the top income tax bracket to $400k; iii) an increase in corporate tax rates; iv) lowering the Federal

Estate Tax exemption from the current $11.7 MM to $1MM; and, v) increased audits for individuals earning over $400k a year. This means higher taxes for wealthy or high earner individuals and possibly a filter down of these higher taxes to the middle class in specific situations.

Note, these are proposed rules, so that does not necessarily mean they will actually be passed or anything similar will be passed. Some liken the proposal to President Biden firing a shot over the bow of wealthy and/or high earner individuals letting them know he means business, but not necessarily being where the tax legislation will end up. As a result, there are two schools of thought: one to act now, and, one to wait and see. The taxpayers acting or scrambling now believe the new rules will be close to what the President has proposed and hope the capital gains tax rules will not be applied retroactively or realize they need to sell anyway due to business or personal reasons.

The individuals willing to "wait and see" assume there will be a political process for these proposals to turn into laws requiring a wrestling between various interests. For all they know, none of these proposals will be passed and enacted, or a completely different tax scheme may be enacted that looks nothing like the proposed rules. It may take years to iron out final rules or the government may decide to delay changes to not derail a COVID recovery. The taxpayers who are acting now is comparable to shooting in the dark where you do not know who or what you are shooting at.

That being said, below are the actions certain wealthy or high earner clients are taking to combat or lock in tax savings based on the proposed tax legislation:

1. **Gifting** – Some clients are gifting to take advantage of the $11.7 MM Federal Estate Tax exemption while it is here. If the exemption is lowered with an effective post gift date to $1 MM, this will potentially save over $4 MM in federal estate taxes plus remove future gains from one's estate. Additionally, if there is ultimately a forced recognition of capital gains at death this postpones this unrealized tax bill to the next generation assuming the gift is not treated as a recognition event itself.

2. **Recognizing Gains Now** – Some wealthy or high earner taxpayer clients are trying to recognize taxable capital gains in 2021 hoping they will be taxed at the current 20% tax rate instead of proposed 39.6% tax rate. However, there is a risk if the rate increase is ultimately effective retroactively to January 1, 2021 or even April 28, 2021. These clients will have sealed in the higher 39.6% rate with no ability to possibly defer the taxes until a new regime could potentially repeal the new rules in the future. Then again, the gamble is if the increase does not start until January 1, 2022, they have saved themselves one-half of the tax.

3. **Timing Out Gains** – Some wealthy/high earners clients are trying to time out gains in 2021 and onward in case the proposed rules do become law and are retroactive. For instance, if someone's taxable income is $500k, the person may take $499k in capital gains each year to be just under the $1 MM increased threshold. Individuals may try to time capital losses with those gains to negate the gains and also to stay under the $1MM threshold. Additionally, other clients are considering possibly installment sale treatment for his/her business or asset sales to spread the taxable gains over a number of years to stay under the $1MM threshold. On the other hand, the downside to purposefully taking a gain this 2021 calendar year is if the proposed taxed rules are not passed, the taxpayer loses the time value of deferring that gain into the future. Further, an installment sale runs the risk of the buyer defaulting.

4. **Life Insurance** – Some wealthy/high earner taxpayer clients are having assets appraised to determine the potential tax liability under the new proposed tax scheme and then are buying life insurance to pay the increased death time tax difference. While this is not a perfect cure

as premiums can be steep and some individuals are not insurable due the health issues, it does provide the necessary indirect security that your assets will not be subject to the increased federal estate and capital gains taxes.

5. **Do Nothing** – As stated, some wealthy/high earner individuals are doing nothing. They: i) figure the proposed rules may not even pass; ii) figure the tax legislation that does pass may be drastically different; iii) want to see if the rules are applied retroactively before locking in gains; and/or, iv) believe that even if the proposed rules are enacted exactly as proposed it may take months or years for them to pass or they may be delayed to not derail the COVID economic recovery.

For what your proper course of action should be depends on what you see in the tea leaves. Some see the proposals as saber rattling and negotiation starting points to meet somewhere in the middle, some think they are the new reality, and some think it is a bunch of hot air. Either way, business owners, wealthy individuals/families and high earners should assess where they stand, what their potential liability is, and what fully informed steps they want to take to protect themselves, if any.

This newsletter is courtesy of Pozzuolo Rodden, P.C.

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