PREPARE WHERE YOU CAN AS NEW TAX INITIATIVES COULD BE UNVEILED BY THE BIDEN ADMINISTRATION

By: John Welsh, J.D.

As the Biden administration moves deeper into the year, more and more detail is becoming available on various aspects of his tax proposals. The $1.8 trillion American Families Plan unveiled in late April, demonstrates that the general direction for taxes will be upward, and individually they cover a broad expanse of the American economy. Individual income taxes, capital gains, estate taxes and corporate taxes are all under the microscope. In this Commerce Trust commentary series on tax proposals, we will focus on one area at a time to give readers deeper context. We'll start with estate planning on a bedrock of American wealth – inherited assets. Proposals still face major challenges for passage by Congress, but our perspective is to be out in front of potential tax scenarios that could develop. Commerce Family Office Director John Welsh gives you thoughtful perspective into what you need to know about tax proposals concerning taxation of your estate.

Over the last year we have not only been living in a global pandemic, but also in what seems to be a never-ending discussion of potential tax changes that could be looming for high net worth individuals. Congress recently took a step closer to knowing what these changes could look like and today we would like to dive in and discuss one of those potential changes, the elimination of the step-up in basis. While the elimination of the basis step-up could theoretically be straight forward, it could also be combined with more complicated provisions found in the recently drafted bill, the Sensible Taxation and Equity Promotion Act, otherwise known as the STEP Act.

Before we discuss what is in the STEP Act and what changes to the basis step-up could mean, it is important to remember that the STEP Act and other bills are only preliminary, and will most likely be altered prior to being signed into law. Congress and the White House are effectively controlled by the Democrats with a current ability to pass significant legislation under the Reconciliation process with only 50 votes in the Senate. However, this control is very fragile and will most likely result in bills being softened in order to get 50 Senate Democrats to agree. That means that while it is imperative to start planning for potential changes, taxpayers should not be rushing into any changes without considering the impact of a change if the bills are significantly altered or not enacted at all.

FIRST THINGS FIRST, WHAT IS BASIS STEP-UP AND WHY SHOULD YOU CARE ABOUT IT?

When someone sells property, the owner incurs a capital gains tax on the difference between the amount received through sale and the cost basis of that asset. The basis of that asset is typically the original purchase price and can be adjusted for the cost of any improvements and for any depreciation claimed.

For example, if Mary buys a stock for $100 and later sells it for $500, she owes capital gains tax on the $400 appreciation of the stock. However, if Jack inherits that stock from Mary, under today's laws his cost basis would be "stepped up" to the fair market value of the stock at Mary's death, let's assume $500. If Jack later sells that asset, his cost basis of $500 would be used in calculating any capital gains to be taxed on his return.

WHAT HAPPENS IF BASIS STEP-UP IS ELIMINATED?

In the simplest version of this, Jack would merely assume the same basis that Mary had in the stock, otherwise known as "carry over" in basis. This rule currently applies to assets that are gifted while someone is alive (with some exceptions). Continuing our example, if Mary gifted that stock to Jack while Mary was living and not at her death, Jack's basis would be $100 and if he sold the asset, he, not Mary, would owe tax on any gain realized.

CURRENT PROPOSALS WOULD ACCELERATE RECOGNITION OF THAT GAIN

Under our example above, if basis step up is eliminated, Jack's cost basis for the stock received from Mary's estate would be $100, the same as her basis. However, he controls the timing of gain – when he decides to sell the asset, that's when the gain would be recognized and he would owe capital gains tax. And if he doesn't sell the stock, he doesn't pay a tax.

Some proposals, including in the STEP Act, would remove that ability to time the imposition of the capital gains tax by taxing the appreciation of the asset at Mary's death, whether the asset was sold or not.

This is called a deemed sale and could apply not only to assets transferred at death, but also on gifts to individuals and irrevocable trusts. The deemed sale would be on Mary's final income tax return and the capital gains would be taxed at her tax rates.

HOW WOULD THIS IMPACT THE ESTATE TAX? The current proposal does not include any changes to the estate tax exemption amount nor the tax rate on estates. If there is a deemed sale at death and capital gains tax is imposed on the appreciation of the assets, there may be some credit or reduction in value for estate tax purposes. This credit or adjustment would most likely not be a dollar for dollar credit and both taxes would apply.

Together, the taxes imposed on taxable estates could increase dramatically if there are low basis assets held at death.

IS THERE ANYTHING ELSE I SHOULD KNOW ABOUT A POTENTIAL ELIMINATION OF BASIS STEP UP? Most of the proposals have provided for some level of exclusion. As an example, there could be an exclusion amount applied to the first $1 million of gain (or more) at death; a lifetime exclusion amount in addition to the exclusion amount at death; an exclusion on gain up to $500,000 (or more) from transfer of a personal residence; a 15-year time period to pay the tax due on a transfer of certain assets like a closely-held business or farm; and last, there could be a deemed sale on assets held in irrevocable trusts after a certain time, such as 21 years after the trust was created. If this deemed sale were enacted, trusts created many years ago would be subject to the tax.

IF I WANT TO PLAN AHEAD FOR THIS CHANGE, WHEN WILL THIS TAX BECOME EFFECTIVE? There has been much discussion on when any tax change could become effective. Generally, there are three options if Congress passes legislation sometime between now and the end of 2021. Congress could delay the effective date to a future date, such as January 1, 2022, giving taxpayers time to potentially plan around the impact of the changes. Congress could decide to use the date the legislation is enacted or introduced. Or Congress could choose the harshest option and make it retroactive to January 1, 2021, meaning there is no time to plan ahead and all transactions undertaken this year are subject to the tax. While the STEP Act uses the harshest date and applies the law retroactively, many experts believe it will be difficult to convince all 50 Democratic Senators to apply the changes retroactively. At this time, all options are possible and there are too many unknowns for anyone to feel confident about making solid predictions.

NOW THAT I KNOW THE INS AND OUTS, HOW COULD THIS IMPACT MY FAMILY? Let us continue our example with Mary and Jack and look at the impact a potential elimination of basis step up could have on families. In our example below, Mary holds a large position in the stock, which she bought for $1,000,000 and is now worth $5,000,000. Under current law (and assuming no estate tax is due), Jack could inherit the stock from Mary, get a basis step up and sell the stock while paying no tax, netting the entire $5,000,000. If basis step up is eliminated, Jack could owe $714,000 in taxes, netting only $4,286,000.

	STEP UP ALLOWED	NO STEP UP ALLOWED
VALUE OF STOCK AT MARY'S DEATH	$ 5,000,000	$ 5,000,000
JACK'S BASIS IN STOCK	$ 5,000,000	$ 1,000,000
EXCLUSION AMOUNT	$ -	$ 1,000,000
AMOUNT SUBJECT TO TAX	$ -	$ 3,000,000
CAPITAL GAINS TAX OWED	$ -	$ 714,000
NET AMOUNT TO JACK	$ 5,000,000	$ 4,286,000

Another change under consideration is an increase to the capital gains rate is being discussed. If the capital gains rate is increased from a max of 23.8% to 43.4%, Jack could owe up to $1,302,000 in tax and only net $3,698,000 from the sale of the stock.

	STEP UP ALLOWED	NO STEP UP ALLOWED
VALUE OF STOCK AT MARY'S DEATH	$ 5,000,000	$ 5,000,000
JACK'S BASIS IN STOCK	$ 5,000,000	$ 1,000,000
EXCLUSION AMOUNT	$ -	$ 1,000,000
AMOUNT SUBJECT TO TAX	$ -	$ 3,000,000
CAPITAL GAINS TAX OWED	$ -	$ 1,302,000
NET AMOUNT TO JACK	$ 5,000,000	$ 3,698,000

If basis step up is eliminated and the capital gains rate is increased to 43.4%, the combined capital gains tax and estate taxes could increase the effective tax rate to over 60% for transfer of an asset with no basis by a taxpayer with no exemption amount and no capital gain exclusions. This could leave heirs with only 40 cents for every dollar received from their parents and could ultimately be too much for moderate politicians.

THOSE ARE SOME SERIOUS IMPACTS. WHAT CAN I DO NOW TO PLAN AHEAD? As we said above and have said over the past year, taxpayers should be planning for these potential changes now. Unfortunately, there is too much uncertainty around these changes for taxpayers to actively implement changes now without possible negative consequence should Congress be unable to pass significant legislation.

Some things that taxpayers should think about and look at as we move closer to real legislation:

1. Understand how much unrealized gains you have in all your assets and who owns the asset (e.g. individual, revocable trust, irrevocable trust, retirement account, etc.).
2. Begin or continue to use loss-harvesting techniques such as some form of tax management equity.
3. Consider the impact of gifting certain low-basis assets to charity, at death or during life.
4. Draft all trusts with flexibility in mind to allow for strategic use of assets for charitable purposes.
5. Analyze current grantor trusts to determine impact of turning off grantor trust status while considering the impact of gifting assets that will appreciate during your lifetime now to avoid paying the capital gains tax on a deemed sale at death or transfer as well as limiting estate tax exposure.
6. Compare how life insurance policies can limit potential future taxes against taxable returns on assets outside of life insurance.
7. Consider using gifting strategies that utilize valuation discounts to limit the value of the asset transferred and thus limit the potential capital gains and estate tax liabilities.

At Commerce Trust Company, we will continue to monitor this fluid situation as proposals are modified and additional information becomes available. We will provide further updates in this space and as always, encourage clients to contact their relationship managers and tax consultants as needed.*

*Always consult with your CPA and professional advisor on matters involving taxes.

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ABOUT THE AUTHOR

JOHN WELSH, J.D.

Senior Vice President, Director, Commerce Family Office at Commerce Trust Company

John is a managing director of Commerce Family Office in St. Louis. He collaborates closely with clients on strategies for addressing the complex personal, family, and financial challenges that can accompany significant wealth and often impact current and future generations. John works to help clients integrate core values into wealth planning and decision making, translate vision and mission statements into actionable solutions, implement successful family communication strategies, and establish effective family governance structures and processes. Prior to joining the Commerce Family Office team, John was a Family Wealth Strategist in Chicago, where he worked with families and individuals on the development and implementation of estate, wealth transfer, philanthropic, family education and fiduciary planning activities, as well as a variety of wealth planning matters. Prior to that, John was an attorney where he was a part of the Private Client group providing wealth and estate planning services to ultra high net worth individuals, families, family offices and foundations. John earned his Bachelor of Business Administration from the University of Notre Dame and his Juris Doctor from Northwestern University School of Law.

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