# Before the Election: 4 Smart Planning Moves to Consider

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**With every election there is a chance for major policy changes, and as a financial advisor it is crucial to plan for the possibilities. Here are the four major tax changes we could see in the near future and tax planning strategies that may make sense now.**


Although we cannot be certain what will happen on November 3rd, we know that with every election there is a chance for major policy changes. Specifically, Biden's tax proposal includes plans for a massive rehaul of the tax code and higher taxes for many clients. As a financial advisor or tax professional, it is crucial to plan (and possibly act now, especially for individuals that are above the $400,000 income threshold) before the election in less than a month.

Here are the four major tax changes we could see in the near future and tax planning strategies that may make sense to act on before it is too late.

### 1. Increased taxes for those making $400,000 and up

Based on Biden's proposal and his own comments, his target is those with earned income of $400,000 or higher. Biden plans to increase the top income tax rate for individual incomes above $400,000 from 37% (under the current law) to the pre-Tax Cuts and Jobs Act (TCJA) level of 39.6%. With this, there will likely be a cap on the itemized deductions to 28% of value, which means taxpayers with tax rates higher than 28% will face limited itemized deductions.

Additionally, Biden looks to reinstate the Pease limitation, which was suspended through 2025 under the TCJA, for individuals above the $400,000 in income. By bringing this back, the limitation would reduce itemized deductions by 3% of adjusted gross income in excess of the $400,000 threshold.

As the law stands now, qualified pass-through business deductions, which allow small business owners to deduct up to 20% of their business income under the TCJA, are capped at $163,300 for single filers and $326,600 for joint filers in 2020.

However, for individuals and couples earning over these thresholds, a passel of rules determines whether or not you are allowed to take qualified business income (QBI) deductions. Biden's plan aims to simplify this by keeping QBI deductions in place for those with less than $400,000 in earnings but phasing out pass-through deductions for those with over $400,000 in earnings.

Lastly, Biden plans to impose a 12.4% payroll tax on income earned above $400,000, evenly split between employers and employees. This would create a donut hole in the current Social Security payroll tax where wages between $137,700 (the current wage cap), and $400,000 are not taxed. Currently, only $137,700 in wages are subject to this tax, which is 6.2% and employers are required to pay another 6.2%. In Biden's plan, those who are self-employed will carry the entire 12.4% themselves.

### Actions to take

- **Accelerate income:** If your client is expected to earn more than $400,000 per year, they may save tens of thousands of dollars if they accelerate some of their expected income to 2020. In addition, if there are bonuses (over and above the $400,000 in income), it may make sense to have them paid out before the New Year to save on ordinary income taxes and Social Security taxes.
- **Push back deductions:** If tax rates are expected to increase, the strategy is to push deductions to the following year so that you can offset income that would otherwise be taxed at the higher rate. A higher tax rate makes a deduction more valuable, while a lower tax rate makes a deduction less valuable, and the deductions should be shifted either forward or backward to whichever year is anticipated to yield the highest tax rate savings.
- **Consider Roth conversions:** Due to the potential large increase in taxes for those with income greater than $400,000, Roth conversions in 2020 can help defend against the potential for higher taxes for your clients as well as their heirs. In addition, this is the optimum time to project the tax cost of a conversion, because most people by this time will have a reliable estimate of their 2020 income.

  Some clients may think they will be in a lower tax bracket in retirement, but that doesn't often happen, especially after a spouse dies and the surviving spouse sees their tax bills increase when they begin to file as single. Even if it turns out taxes do not increase (which is unlikely) or that maybe taxes go even lower for some clients (even more unlikely), the tax rate on Roth distributions in retirement will be zero. That is not a bad worst-case scenario. The bottom line is that if your client has a large traditional IRA balance, a Roth conversion removes the risk and uncertainty of what future higher tax rates can do to a client's retirement income, and it may make sense to do the conversion now while rates are lower.

## 2. Taxes on capital gains could dramatically increase

Capital gains taxes were reduced under the TCJA to 0%, 15% or 20% depending on the taxpayer's income level. If Trump wins, this structure may likely remain the same, but under Biden's plan, taxes on capital gains could almost double to 39.6% for taxpayers with income over $1,000,000.

### Actions to take

- **Accelerate gains:** With this great of a potential increase in the capital gains tax rate, it may make sense for clients with appreciated assets to consider selling before the end of the year to lock in the current more favorable tax rates. In addition, clients who are expecting a liquidity event or stock option sale in the future may want to consider doing so in 2020.
- **Defer unrealized losses:** Under a Biden tax plan, losses become more valuable. Taking a look at harvesting unrealized losses in stock portfolios could help to offset gains in other assets or create a tax deduction for those losses. Consider taking those losses in future years.

## 3. Estate taxes are likely to increase

Under the TCJA, Trump increased the gift and estate tax exemption from $5,000,000 to $10,000,000 and now $11,580,000 per individual (with inflation adjustments). Therefore, married couples are able to transfer assets of $23.16 million without incurring federal tax. Clients can gift up to this amount without paying any tax on it during their lifetime, and any remaining exclusion can be used to offset estate taxes at death. Per Biden's proposal, he may reduce the exemption to a level closer to its historical norm (which could be around $5,000,000 or even less).

### Actions to take

- **Gift now:** For high-net-worth investors with estates valued at $10 million or more, it may be a good idea to use as much of the lifetime exclusion now rather than wait, as clients may only have four months left in 2020 to use the higher exemption. When gifting, the assets are no longer part of the estate which helps to avoid gift and estate tax on all future appreciation of the gifted asset and if the recipient is in a lower tax bracket, the annual income earned on the asset will be taxed at a lower rate. Finally, the IRS has agreed not to claw back any of those gifts made, so consider making them in 2020.
- **Consider grantor retained annuity trusts.** Consider setting up grantor retained annuity trusts, or GRATs, before the estate planning lifetime exclusion gets decreased and before GRATs are banned. This estate planning technique allows for the transfer of appreciated assets with minimal or no tax. With a GRAT, the grantor transfers assets into a trust for a term of years and during the term, the grantor receives an annuity payment of either a fixed dollar amount or fixed percentage of the fair market value of the assets placed into the trust.

  Since the gift being made is calculated at the inception of the GRAT, it is potentially beneficial because if the contributed assets grow faster than the IRS assumes (current rate of 0.40% monthly as of October 2020), the beneficiaries will receive a much larger gift than was required to report. This technique leverages the estate and gift tax exemption available. Further, a GRAT can be designed to be zeroed-out, which eliminates any gift tax or use of the grantor's available lifetime exemption upon its creation.

## 4. The cost basis step-up of bequeathed assets may be eliminated

The current law states that heirs can receive appreciated assets with a step-up in basis to the asset's fair market value at the time of death. Therefore, appreciated assets can be transferred at death without a capital gains tax liability. Biden is proposing to eliminate this step-up in basis at death, which could result in a big income tax bill at death (gains will be recognized) even if the beneficiaries do not sell the asset. This may create a huge tax liability that might force heirs to sell the asset to pay the taxes.

### Actions to take

- **Decrease the size of estates:** If the step-up in basis is eliminated (coupled with the lower exemption ceiling), it is important to start thinking about how high-net-worth clients can get assets out of their estate before the laws are overhauled. Also consider selling assets while still alive and paying the taxes, which is another form of gifting. Interest rates are at record lows, which makes accelerating gifting programs and repositioning assets key. If a client has been sitting on valuable real estate or business interests that are likely to appreciate, now is the time to consider gifting strategies such as GRATs or charitable trusts.

## Are your clients at risk?

Given the possibility of significant tax changes heading our way, it is important to take advantage of the current tax laws and low tax environment. These tax changes could affect many Americans and especially the wealthy. With the election approaching rapidly, acting now may be crucial for reducing your clients' (and potentially their heirs') tax liability.