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POSSIBLE FEDERAL TAX LAW CHANGES ON THE HORIZON

With the COVID-19 vaccination rates accelerating in the U.S. and the pandemic easing in many parts of the country, the U.S. economy continues to improve with the latest unemployment report indicating a strong recovery – the best gains since August 2020. As stay-at-home orders are lifted and more states permit businesses to fully reopen, the Biden Administration has shifted its attention to upgrading the nation's aging infrastructure.

As of April 2021, the recently proposed *American Jobs Plan*, seeks to address deferred maintenance by modernizing roads, bridges and highways across the country, investing in clean energy, and incentivizing advanced research and development and manufacturing in order to enhance the nation's competitiveness on the global stage. A key component of this \$2 trillion infrastructure plan is the *Made in America Tax Plan* which seeks to generate revenue by raising taxes on high net-worth individuals and corporations.

The following article outlines the federal tax proposals presented in the *Made in America Tax Plan*, specific additional estate and gift tax proposals introduced by Congressional Democrats, additional tax changes proposed by President Biden during the 2020 election, as well as possible strategies to consider in advance of any changes. It is important to note that this is a fluid situation which will evolve over the next several months and what is being presently proposed will most likely change over time. These proposed changes should be viewed through the lens of your personal goals and priorities and may help inform any actions you may want to take.

Proposed Federal Tax Changes Impacting High Net-Worth Individuals

One of the main features of the Biden Tax Plan during the campaign was the rollback of the *Tax Cuts and Jobs Act of 2017* (TCJA). The TCJA significantly raised the threshold for the imposition of income and transfer taxes for many high net-worth individuals, estates and pass-through entities. Many provisions of the TCJA are scheduled to sunset (expire) at the end of 2025 for budgetary and procedural reasons, but the focus now is whether the TCJA will even survive until the end of 2021.

PERSONAL INCOME TAX

Ordinary Income: The *Made in America Tax Plan* codifies the rollback of the TCJA by raising the top tax bracket from 37% to 39.6% for taxable income over \$400,000. Currently, the highest tax bracket begins for taxable income greater than \$518,400 for individuals and greater than \$622,050 for married couples filing jointly. The Biden Administration proposal makes changes to all tax brackets as follows:

- **Proposed Tax Brackets:** 10%, 15%, 25%, 28%, 33%, 35% and 39.6%.
- **Current Tax Brackets:** 10%, 12%, 22%, 24%, 32%, 35% and 37%.
- **Possible Strategy:** Accelerate ordinary income items this year in order to take advantage of lower ordinary income tax-rates (bonus acceleration, exercise non-qualified stock options, convert Traditional IRAs to Roth IRAs).

Capital Gains: The Biden Administration proposes the elimination of the favorable 20% tax rate on long term capital gains and the application of the top ordinary income tax rate of 39.6% – including the 3.8% Medicare Surtax – for a total tax rate of 43.4% for individuals with taxable income over \$1 million.

- **Current Tax Law:** Total top tax rate of 23.8% (20% + 3.8% Medicare Surtax) applies to individuals with taxable income greater than \$445,850 and \$501,600 for married couples filing jointly.
- **Possible Strategy:** Recognize long-term capital gains for 2021 in order to use the lower favorable tax rate available now. Consider accelerating taking capital losses to offset capital gains.

Itemized Deductions: The Biden Administration proposes capping itemized deductions for single filers and married couples filing jointly to those with blended tax rates of up to 28%. Individuals would receive full itemized deductions if blended tax rate is less than or equal to 28%. For blended rates greater than 28%, itemized deductions will be gradually lowered according to the percentages set forth under the Pease Limitation (see below for detailed explanation).

- **Proposed Tax Law:** Certain itemized deductions which were capped would be brought back as follows:
 - Deduction for state and local taxes (SALT) would be uncapped, allowing full SALT deduction, subject to decrease due to the Pease Limitation and Alternative Minimum Tax (AMT) calculation.
 - Deduction for real property tax would be uncapped, subject to decrease due to Pease Limitation and AMT calculation.

- **Current Tax Law:** Limitation or elimination of many itemized deductions including:
 - SALT and real property tax deductions are capped at \$10,000 total.
 - Mortgage interest deduction is limited to \$750,000. Home equity loan interest may be included as part of the \$750,000 limit if the home equity loan is used specifically for improvements related to the home.
 - Deductions for theft, personal casualty, tax preparation fees and unreimbursed employee expenses are all eliminated.
 - The standard deduction increased to \$12,000 for single filers and \$24,000 for married couples filing jointly in 2018, indexed for inflation. For 2021, the standard deduction is \$12,550 for single filers and \$25,100 for married couples filing jointly.

Pease Limitation: The Biden Administration has proposed reinstating the Pease Limitation for individuals and married couples filing jointly with taxable income greater than \$400,000. Pease Limitation was enacted in 1992 to limit the amount of itemized deductions available for high income earners. It was fully repealed under President Bush in 2009, reinstated by President Obama in 2013, and repealed again under President Trump in 2017. The Pease Limitation begins reducing the itemized deductions for taxpayers upon reaching a certain threshold adjusted gross income (AGI) amount. Itemized deductions are lessened by 3% for every \$1 above the threshold amount. The reduction is limited to 80% of taxpayer's total itemized deductions.

- **Proposed Tax Law:** The reinstatement of the Pease Limitation.
- **Current Tax Law:** The elimination of the Pease Limitation.

Alternative Minimum Tax: The Biden Plan calls for the reinstatement of the Alternative Minimum Tax (AMT) for most taxpayers.

- **Proposed Tax Law:** The application of the AMT exemption phase-out calculation that was in place prior to the enactment of the Tax Cuts and Jobs Act of 2017.
- **Current Tax Law:** The maximum AMT tax rate stands at 28%. For 2021, the AMT exemption amounts are \$73,600 for single filers and \$114,600 for married couples filing jointly. Exemption phase-outs begin at \$523,600 for single filers and \$1,047,200 for married couples filing jointly. Therefore, most taxpayers do not fall within AMT since once the exemption phases out, their blended tax rates are above 28%.
- **Possible Strategy:** Accelerate AMT income items such as exercising incentive stock options.

Social Security (Payroll) Tax: The Biden Administration proposes adding an additional 12.4% Social Security Payroll Tax (6.2% on Individuals and 6.2% on Employers) for taxpayers with earned income over \$400,000 – while eliminating the Payroll Tax for earned income between \$142,801 to \$400,000.

- **Current Tax Law:** Social Security Payroll Tax of 6.2% on employee's wages of up to \$142,800. Social Security Wages indexed for inflation on an annual basis.

Pass-Through Income Tax Deduction for Small Businesses: The Biden Plan proposes the phase-out of the 20% pass-through income tax deduction for small business owners with taxable income exceeding \$400,000.

- **Current Tax Law:** A 20% income tax deduction for small business owners earning taxable income greater than \$400,000.

Taxation of Carried Interest: During the 2020 presidential campaign, then-candidate Biden proposed that carried interest – the share of profits that the general partners of private equity and hedge funds receive as compensation or performance fee – should be taxed as ordinary income.

- **Proposed Tax Law:** Carried interest taxed at the top ordinary income tax rate of 39.6%.
- **Current Tax Law:** Carried interest taxed at the preferential capital gains tax rate of 20%. In August 2020, the IRS issued proposed regulations that state, in part, that for carried interest to qualify for capital gains treatment, there must be a holding period of at least 3 years before carried interest distribution to the private equity principal. If held less than 3 years, carried interest distribution is treated as ordinary income. The proposed regulations have not yet been finalized.

Tax Treatment of 1031 Like-Kind Exchanges: The Biden Plan proposes the elimination of 1031 exchanges – the deferral of capital gains tax by exchanging like-kind investment property for another – for real property.

- **Proposed Tax Law:** The elimination of 1031 exchanges for real property.
- **Current Tax Law:** 1031 exchanges are only allowed for real property; 1031 exchanges for business and personal property are eliminated.

TRANSFER TAX

Estate and Gift Tax: The main focus of the Biden Administration and many Congressional Democrats is redressing U.S. income inequality by raising taxes on high net-worth individuals. During the 2020 presidential campaign, Biden proposed reducing the estate and gift tax exemptions to levels in existence prior to the implementation of the Tax Cuts and Jobs Act of 2017 – approximately \$5.5 million exemption and the imposition of a 45% transfer tax rate for transfers made above that threshold. Additionally, Democrats in the U.S. Senate have recently introduced legislation that drastically changes the estate and gift tax rates and fundamentally alters the advantages of certain wealth transfer strategies for affluent taxpayers.

- **Proposed Tax Law:** Legislation introduced by Senator Bernie Sanders entitled *For the 99.5% Act* proposes reducing the estate tax exemption to \$3.5 million (indexed for inflation), and reducing the gift tax exemption to \$1 million (not indexed for inflation). Additionally, the transfer tax rate would significantly increase for transfers exceeding the exemption levels as follows:
 - 45% Tax Rate: Transfers above \$3.5 million to \$10 million
 - 50% Tax Rate: Transfers above \$10 million to \$50 million
 - 55% Tax Rate: Transfers above \$50 million to \$1 billion
 - 65% Tax Rate: Transfers above \$1 billion
- **Current Tax Law:** The estate and gift tax exemption for 2021 is \$11.7 million. A transfer tax rate of 40% applies to transfers exceeding this exemption level.

Step-up in Basis at Death: The Biden Plan calls for repealing the step-up in basis by taxing the unrealized appreciation of assets transferred at death. Another Democratic proposal recently introduced in the U.S. Senate – the *Sensible Taxation & Equity Promotion Act* – calls for a partial repeal of step-up in basis by providing a \$1 million exemption for unrealized appreciation of assets transferred at death.

- **Current Law:** Full step-up in basis to fair market value at date of death for assets transferred at death.

- **Possible Strategy:** Consider making gifts now to take advantage of the higher gift tax exemption amount by establishing a Grantor Retained Annuity Trust (GRAT), an Intentionally Defective Grantor Trust (IDGT), a Spousal Lifetime Access Trust (SLAT) or an Irrevocable Grantor Trust (IGT) in order to transfer assets out of your estate.

Annual Exclusion: For 2021, individuals are permitted to gift up to \$15,000 a year (\$30,000 for married couples) without application of transfer taxes.

- **Proposed Tax Law:** The *For the 99.5% Act* proposes that individuals would only be able to gift up to \$10,000 per recipient and imposes a new aggregate per-donor limit on certain transfers equal to twice the annual exclusion amount in effect for the year. Transfers subject to this new, additional per-donor limit include:
 - Transfers into a trust;
 - Transfers of an interest in certain family entities;
 - Transfers of an interest in an asset that is subject to a prohibition on sale; and
 - Transfers of an asset that cannot be immediately liquidated by the recipient.

Valuation Discounts: Current law allows for certain valuation discounts for lack of control and lack of marketability to be applied to transfers of interests in intra-family business entities such as Family Limited Partnerships (FLPs) and Family Limited Liability Companies (FLLCs).

- **Proposed Law:** The *For the 99.5% Act* would eliminate discounts for lack of control if the transferor, transferee and family members have control or majority ownership in a non-actively traded interest, as well as eliminate discounts for lack of marketability if there is no material participation in the entity.
- **Current Law:** Discounts for lack of control (minority interest) and lack of marketability are available for transfers of intra-family business interests.
- **Possible Strategy:** Accelerate gifting of interests in intra-family business entities to family members (outright, irrevocable trusts) in order to capture valuation discounts while they still can be applied – thus utilizing a smaller amount of lifetime exemption.

Limitation/Elimination of Certain Wealth Transfer Techniques: While many tax proposals introduced by the Biden Administration seek to roll back major components of the Tax Cuts and Jobs Act, the most significant proposal that will impact high net worth individuals is the limitation or elimination of certain wealth transfer techniques that have become the bedrock of estate planning.

The *For the 99.5% Act* fundamentally changes the viability of the following wealth transfer strategies:

- **Grantor Retained Annuity Trusts (GRAT):** A GRAT would be required to have a minimum 10-year term and a maximum term of the life expectancy of the annuitant plus 10 years. Additionally, the remainder interest could not be less than the greater of 25 percent of the value of the assets transferred to the trust or \$500,000, and not more than the fair market value of the property in the trust.
- **Legacy Trusts/Dynasty Trusts:** The generation skipping transfer (GST) tax exemption could not be allocated to a trust classified as a non-qualifying trust – a trust that has a termination date that is more than 50 years after the date in which the trust was created. The proposed law would categorize specific trusts as follows:
 - A qualifying trust must terminate no more than 50 years after the trust is created; and
 - Any pre-existing trusts (trusts in existence before the change in law) must terminate within 50 years of enactment.

- **Grantor Trusts:** The *For the 99.5% Act* applies transfer tax rules to certain grantor trusts. For example, an Intentionally Defective Grantor Trust (IDGT) is a grantor trust in which the grantor is permitted to remove assets out of his/her estate by transferring assets to the trust and paying the income tax for the trust as a transfer tax-free gift – an added benefit to the trust beneficiaries. The proposed law, however, would:
 - Include the assets of that trust in the gross estate of the grantor for estate tax purposes;
 - Impose a gift tax on any distributions from the trust to one or more beneficiaries during the grantor’s life; and
 - Impose a gift tax on the remaining trust assets if at any time during the grantor’s life the grantor ceases to be treated as an owner of the trust for income tax purposes – whereby the trust becomes a non-grantor trust.

Wealth Planning Strategies to Consider: While there is no certainty regarding which federal tax plans that have been proposed by the Biden Administration and various Democratic lawmakers will be enacted, it is still important to consider certain strategies in preparation for any changes that may be on the horizon:

- **Leverage the Higher Lifetime Exemption Amounts for 2021:** Transfer assets out of your estate to take advantage of higher lifetime exemption amounts.
- **Accelerate the Establishment and Funding of Certain Trusts:**
 - **Grantor Retained Annuity Trust (GRAT):** Gift of appreciating assets to irrevocable trust in exchange for annuity interest. Remainder interest passes to beneficiaries when the trust term ends. Value of gift discounted based on the payout rate and term of years of the GRAT. The new GRAT rules would apply to transfers made after the date of enactment, so pre-existing GRATs would be grandfathered and not impacted by the new law.
 - **Intentionally Defective Grantor Trust (IDGT):** Gift or sale of appreciating assets to an irrevocable trust. At least 10% of the value of the trust (“seed”) is gifted to the trust to qualify for IDGT status. The remaining assets (up to 90%) may be sold to the trust in return for a promissory note. The designated interest rate for the promissory note would be set at the current applicable federal rate – which is at historically low levels. This freezes the value of the asset transferred to the IDGT in the grantor’s estate. All future appreciation above the interest rate on the promissory note is removed from the estate. The grantor is responsible for all tax due on income generated within the IDGT, which provides an additional benefit to the trust beneficiaries. Because the proposed new rules for grantor trusts would apply to (1) trusts created after enactment; (2) transfers made to pre-existing trusts after enactment; and (3) sales to pre-existing trusts – under the *For the 99.5% Act* existing trusts with no additional transactions (transfers, exchanges or sales) would be grandfathered.
 - **Spousal Lifetime Access Trust (SLAT):** Each spouse transfers interest in an asset to a SLAT for the benefit of the other spouse. The beneficiary-spouse serves as a trustee of the SLAT. By transferring the asset during their respective lifetimes, each spouse “freezes” the value of the asset as of the date the transfer is made. Future appreciation is not subject to gift or estate tax, and the asset itself will not be included in either spouse’s estate. However, the beneficiary-spouse will receive distributions from the SLAT for his or her health, education, maintenance and support, thereby enabling continued access to the asset and its income during the spouses’ lifetimes.
 - **Irrevocable Grantor Trust (IGT):** Gift is made to an irrevocable trust. All future appreciation is removed from the estate. IGT usually includes language that allows the grantor to “substitute” assets of equal value to the trust to reacquire trust assets. This “power of substitution” makes the trust a “grantor” trust. Therefore, the grantor is responsible for all tax due on income generated within the IGT, which provides an additional benefit to the trust beneficiaries.

- **Capture Valuation Discounts:** Gift interests in intra-family business entities such as Family Limited Liability Company (FLLC) and Family Limited Partnership (FLP) to take advantage of valuation discounts for lack of marketability and lack of control. Because the proposed changes to valuation rules would be effective to transfers made after the date of enactment, any discounted gifts made prior to the passage of the law limiting valuation discounts would be grandfathered.

Proposed Federal Tax Changes Impacting Corporations

As part of the *Tax Cuts and Jobs Act of 2017*, the corporate income tax rate was lowered from 35% to 21%. While a significant number of tax changes stemming from the law are set to expire at the end of 2025, the tax cut for U.S. corporations is permanent. The Biden Administration, however, has proposed raising the tax rate to 28% for domestic income and 21% for income generated in foreign countries, and is also advocating for a global minimum corporate tax rate – making it harder for corporations to relocate business operations to countries with low income tax regimes. Additionally, the proposed law would impose a 15% minimum tax on the financial statement income (book income) of large corporations – as part of an overall global initiative to prevent companies from avoiding corporate taxes.

While opponents to increasing corporate tax rates argue that such changes will put U.S. corporations at a competitive disadvantage to their foreign counterparts, proponents argue that a significant number of these companies pay a far lower effective tax rate based on tax deductions and credits. However, moderate Congressional Democrats are hesitant to raise the rate to 28% and have proposed a 25% tax rate.

- **Proposed Law:** Increase the corporate income tax rate to 28% for domestic income and 21% for foreign income; minimum 15% tax rate for book income.
- **Current Law:** 21% corporate tax rate lowered from 35% rate following enactment of the *Tax Cuts and Jobs Act*.

Conclusion

While it is necessary to consider any potential tax law changes, it is even more important to evaluate these proposals within the context of your personal goals and priorities and take appropriate action based on your short-term and long-term objectives in consultation with your tax and estate planning advisors.

The tables below provide an overview of current law and tax proposals recently introduced by President Biden and Congressional Democrats.

Personal Income Tax	Current Law	Biden Proposal
Top Rate	37%	39.6%
	Above \$518,400 (Sunsets 12/31/25)	Above \$400,000
Capital Gains Tax	<ul style="list-style-type: none"> 20% Rate 3.8% Medicare Surtax 	<ul style="list-style-type: none"> Ordinary Income Tax Rate for Taxpayers Earning \$1 Million – 39.6% Rate 3.8% Medicare Surtax
Social Security & Medicare Taxes	6.2% on Wages Up to \$142,800 (indexed for inflation)	6.2% on Wages Up to \$142,800 and Over \$400,000

Personal Income Tax	Current Law	Biden Proposal
Itemized Deductions	<ul style="list-style-type: none"> Pease Limitation on deductions repealed in 2017 State & Local Tax (SALT) and Real Estate Tax limited to \$10,000 20% Deduction for Qualified Small Business Income 	<ul style="list-style-type: none"> Reinstatement of Pease Limitation on deductions No limit of SALT or Real Estate Tax deductions (except overall deduction limits) Phase-out of Small Business Pass-Through Deduction
Alternative Minimum Tax	Impact muted by increased Phase-Out limits	<ul style="list-style-type: none"> Return to pre-TCJA exemption levels Full benefit of Itemized Deductions capped at 28%
Carried Interest	Treated as Capital Gains	Treated as Ordinary Income
1031 Like-Kind Exchanges	<ul style="list-style-type: none"> Not allowed for Business or Personal Property Only allowed for Real Estate 	Not allowed for Real Estate

Gift & Estate Tax	Current Law	Biden Proposal	Other Democratic Proposals: "For the 99.5% Act"	
Lifetime Exemption	\$11.7 Million (Sunsets 12/31/25)	\$5.5 Million (Return to pre-TCJA level)	Estate Tax: \$3.5 Million (indexed for inflation)	Gift Tax: \$1 Million (not indexed for inflation)
Transfer Tax Rate	40%	45%	45%	\$3.5M-\$10M
			50%	\$10M-\$50M
			55%	\$50M-\$1B
			65%	Over \$1B
Assets Includible in Estate	Step-up in Basis to FMV at Date of Death	Elimination of Step-up in Basis: Tax on Unrealized Appreciation of Assets Transferred at Death	"Sensible Taxation & Equity Promotion Act"	
			\$1M Exempted from Tax on Unrealized Appreciation of Assets Transferred at Death	

Gift & Estate Tax	Current Law	Biden Proposal	Other Democratic Proposals: “For the 99.5% Act”
Annual Exclusion	\$15,000		<ul style="list-style-type: none"> \$10,000 per Donee \$20,000 per Donor (twice Annual Exclusion) per Donor for Certain Transactions
Valuation Discounts	<ul style="list-style-type: none"> Lack of Marketability Lack of Control 	45%	No – for Lack of Marketability if no material participation
			No – for Lack of Control if transferee & family members have control or majority ownership (non-actively traded interest)
Limitation/Elimination of Wealth Transfer Techniques			GRATs
			Dynasty Trusts
			IDGTs

Corporate Income Tax	Current Law	Biden Proposal	
	21%	Domestic Income: 28%	Foreign Income: 21%
		Book Income [Financial Statement Income]: 15% (minimum)	

Source: Tax Cuts and Jobs Act of 2017, American Jobs Plan/Made in America Tax Plan, For the 99 Percent Act, Sensible Taxation and Equity Promotion (STEP) Act, CNR Research.

Important Disclosures

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