Foster Garvey

Larry's Tax Law

Tax Planning Out of Fear Usually Doesn't End Well

By Larry Brant on 2.24.21 | Posted in Federal Law, Tax Planning

It is not unreasonable to anticipate that there will be a federal tax policy transformation following a change in the political control of the White House, the U.S. Senate and the U.S. House of Representatives. What may be unreasonable, however, is making knee-jerk tax planning decisions in anticipation of possible modifications to the Internal Revenue Code (the "Code"). Reactionary planning, unless it is well thought out and is based upon sound business judgment, could end up being disastrous. During the present times, tax advisors and their clients need to be cautious in their tax planning and any related decision-making.

Looking through a lens solely focused on federal taxation, it seems that commentators, tax advisors and taxpayers alike are all worried about the future. Possible tax policy changes on the horizon that are being bantered about include:

- Decreasing the lifetime estate and gift tax exclusion under Code Section 2010, currently calibrated at $11.7 million, to $6 million (where it is scheduled to return to in 2026), or reducing it to an even lower amount.

- Increasing the top capital gains tax rate under Code Section 1(h) from 20 percent to 35 percent or even eliminating a preferential capital gains rate altogether, thereby taxing capital gains at the same rates ordinary income is taxed (exactly what was done in the Tax Reform Act of 1986).

- Eliminating Code Section 1031 so that tax-deferred exchanges of real estate are no longer allowed. Effective in 2018, the Tax Cuts and Jobs Act (the "TCJA") eliminated the ability of taxpayers to defer gains under Code Section 1031 in the exchange of personal property. Eliminating this code section's application to real estate may be a logical extension of the TCJA.

- Eliminating the flat 21 percent corporate tax rate under Code Section 11, returning to bracketed rates reaching 35 to 40 percent on the top end.

- Increasing the top individual tax rate under Code Section 1 in the top two brackets from 35 and 37 percent to 37 and 39.6 percent, respectively. Additionally, collapsing the top two brackets so that taxpayers enter the higher rates at lower levels of adjusted gross income.

- Returning the corporate alternative minimum tax (repealed as part of the TCJA) to the Code under Section 55.

- Increasing the net investment income tax under Code Section 1411 from 3.8 to 4.5 percent.

- Eliminating the 20 percent deduction for "qualified business income" under Code Section 199A (brought into life by the TCJA).

- Keeping the $10,000 deduction limit on individuals for state and local taxes paid (despite the fact that the limitation, added to the Code by the TCJA, was a compromise for lower individual income tax rates).

While none of these changes in federal tax policy are beyond the realm of possibility, taxpayers should not let fear stand in the way of exercising solid business judgment. In recent months, we have seen taxpayers rushing into decisions that they surely would not have made absent the fear of adverse tax changes on the horizon. Some of these frantic decisions include:

- Electing out of installment reporting under Code Section 453 in anticipation of increases in both capital gains and individual income tax rates. Hopefully, the decision was well thought out and considered at the very least: (i) the time value of money, (ii) the ability of the taxpayer to pay the taxes now on gain proceeds that will not be received until sometime in the future, (iii) the expected increase in capital gains rates, (iv) the impact the use of money today for taxes will have on the taxpayer's investment/business viability, and (v) whether the taxpayer can change directions if rates do not rise enough to warrant the decision (hindsight can be 20/20).
- Gifting away wealth to use up all of the taxpayer's current lifetime estate and gift tax exclusion in anticipation that the exclusion will be significantly decreased in the near

future. Using the exclusion, currently $11.7 million, sounds like a prudent decision; however, taxpayers and their tax advisors need to thoroughly review the decision before a taxpayer jumps with both feet into such an expansive gifting plan, including (i) whether the taxpayer can live his or her life as expected without the dissipated wealth, (ii) whether the taxpayer is hindering his or her other wealth transfer plans (e.g., future charitable gifting), (iii) whether the gifts (amounts and recipients) are well thought out, and (iv) whether the gifting vehicles (outright gifts or gifts in trusts) are appropriate.

- Selling capital assets now to avoid any increases in or the elimination of the capital gains income tax rates. Obviously, if it makes sense to sell an asset today for non-tax reasons, the possibility of avoiding the impact of any adverse capital gains tax changes in the near future makes total sense. Selling a capital asset in a rushed manner may not, however, make good business sense, especially if the terms are or the sales price is undesirable.

More than ever before, it is paramount that taxpayers carefully consider matters with both the business and the tax implications in mind. Any planning must take into consideration the possibility of changes in the law and/or the taxpayer's circumstances, and contain alternative plans so that the taxpayer may to adapt to change.

After the TCJA was enacted on December 22, 2017, we saw numerous taxpayers terminate S corporation elections, chasing the favorable 21 percent flat tax rate under Code Section 11. While we warned them that the alluring flat corporate income tax rate may not be here to stay for very long, they still embarked on the road, heading to the land they thought was full of gold and jewels. Unfortunately, for these taxpayers, since their decision to terminate S corporation status was due to a change in tax rates, in accordance with Code Section 1362(g), they will not be able to reelect S status until five years have passed from the effective date of the termination. So, if the termination was effective on January 1, 2019, these taxpayers will not be able to reestablish S corporation status until January 1, 2024. In the event the flat corporate income rate under Code Section 11 is significantly increased or the pre-TCJA bracketed corporate income tax rates are restored before 2024, they may have to endure the rate change for a few years before they can re-elect S status.

The keys to proper tax planning are:

- Thoroughly examining the taxpayer's current facts and circumstances;
- Carefully examining the potential for changes in both the tax laws and taxpayer's circumstances;
- Thoroughly examining the short-term and long-term impact of any plan on both the tax and non-tax aspects of the taxpayer's life;
- Building in flexibility for changing the plan if the attendant facts change, the tax laws change and/or any part of the hypothesis upon which the plan is built proves to be

inaccurate; and

- Making sure the taxpayer's desires and goals do not get overlooked or set on the sideline in the quest to attain tax savings.

Today, with tax policy changes on the horizon, prudent and well-thought-out tax and business planning is ever important. Planning solely in fear of tax law changes may lead to disaster.

Tags: capital gains, Code Section 1031 Exchanges, corporate income tax, federal gift tax, federal taxation, Internal Revenue Code, IRC § 1031 Exchanges, qualified business income, Tax Cuts and Jobs Act