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Evolving Tax Landscape: 2021 Regulatory Outlook

by Dani Stillman

The Greenbook has been available since May, and tax professionals need to ensure they pay close attention to the changes contained within, especially in light of the upcoming tax legislation shifts on the federal and state levels. Here, tax expert Dani Stillman takes a deep dive into how the proposed changes affect corporations, estate planning and more.

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As if the tax landscape had not been rattled enough for tax year 2020, the Biden administration's proposed changes for the 2021 tax year and beyond may change the traditional tax planning season as well. This could be yet another significant shift only a few years after the Tax Cuts and Jobs Act, which shook up 30 years of mostly predictable tax planning.

In May of this year, the Treasury Department issued its "Greenbook," which outlines the current proposals. A few of the largest potential shifts to expect will be the C corporation tax rate, capital gains and qualified dividends rates, the phase-out of the Qualified Business Income ("QBI") deduction, and changes in basis rules for appreciated property transferred by gift to decedents.

Many of these changes, though only in the proposal stage, will affect taxpayers' decision-making in the current year and years going forward as they try to maximize potential gains, minimize the tax bill at year-end, and enter into new merger and acquisition ("M&A") deals. Also on the horizon is the constantly changing political environment for estate tax, where it seems that the favorable step-up for large capital gains transferred with the estate may soon disappear.

C Corporation Rates

With the 2017 Tax Cuts and Jobs Act (TCJA), we saw a slash in the highest corporate tax rate from 35 percent to 21 percent. The Biden administration's proposal could raise this rate to 28 percent. This potential rate increase may affect the structuring of new businesses and major deals and possibly result in the C corporation ("C Corp") as a less attractive entity choice.

Pass-through entities, such as partnerships, LLCs or S corporations, may be a better option should the rates increase. Many states have been adopting the pass-through entity-level tax, which benefits the individual investors as a state and local (SALT) deduction workaround. This state deduction change, along with the overall corporate tax rate, may make it more beneficial to choose a pass-through entity structure, depending on the taxpayer's unique scenario.

QBI Deduction Phase-Out

An increase in corporate tax rates may add to the "pros" list for pass-throughs, but another proposal may take some wind out of the sails: the phase-out of the 20%

qualified business income ("QBI") deduction. For taxpayers earning over $400,000, the deduction could be disallowed entirely. Along with the potential to end special qualifying rules for real estate investors, this could make pass-throughs much less attractive to new businesses. This proposal did not make it into the Greenbook; however the QBI deduction is set to expire at the end of 2025, and it is important to plan for its sunset in the next few years.

Capital Gains Rates

Another proposed change would move the top capital gains and qualified dividends tax rate for certain individuals from 20 percent to as high as 39.6 percent. While planning for the change in corporate rate is important, one additional area of focus will be in the M&A space looking forward. For business owners looking to exit in the coming years, it may be of interest to accelerate the timeline if feasible. As if 2020 and the beginning of 2021 have not been hectic enough for M&A, this shift in the top rates could spur activity even further. Current guidance does not indicate whether the change would apply retroactively, and if not, that gives some time to plan for clients seeking to exit or retire in the near future.

Estate Planning

In April, the American Families Plan introduced the proposal to end the ability to step up the basis for estate transactions involving gains over $1 million. Additionally, the Greenbook proposal would treat transfers of appreciated property by gift or on death as realization events. This means that the transfer of the property will now be considered a sale, and any gain would be treated as income of the donor or decedent.

The acceleration of the estate tax liability is an important factor to consider in current and future estate tax planning. Clients may want to begin their planning earlier to ensure the best outcome with these changes. Gifting and other tools can potentially be beneficial to lower the liability at the time the estate is eventually transferred.

Planning Ahead

Proposed rate increases across the board will change the tax landscape we have just barely gotten used to over the past few years. Combined with the sunset of many provisions from the Tax Cuts and Jobs Act, there are multiple moving parts to pay attention to in the next few years.

With the changes in the C Corp tax rate and sunset of the QBI deduction, it will be important to pay attention to entity structuring to determine the optimal organization structure for each business. Other clients may want to accelerate their already-planned exit from their company into the current year to avoid the impact of a potentially higher tax environment once these changes take effect. For high net worth clients, it is imperative to pay attention to the evolving estate tax climate. It seems likely that estate tax rates and exemptions will only become less beneficial in the future based on current trends. It is important to evaluate all of these possibilities on a case-by-case basis to determine what is right for each client.

Proper tax planning will be essential for generating the best outcome possible in this ever-changing tax environment. It is not yet known which of the Greenbook proposals will pass and when, but we can use it as a playbook to keep our clients on the front line of the developments.