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Strategies to Mitigate Tax Increases

As a candidate for President, Joe Biden made no secret of his plans for tax increases once in office. Government spending on COVID-19, in addition to existing debt obligations, has all but assured legislation will be advanced to raise taxes later this year.

The policies contemplated target affluent individuals, many of them owners of closely held companies. In preparing for tax increases, many business owners are turning to a number of strategies, including the use of cash value life insurance as an effective tool to replace lost liquidity for their companies and their families.

Proposed Tax Policies

Recent tax increases proposed by President Biden and Congressional Leaders target high-income or affluent individuals and business owners include:

- Increasing the top ordinary income tax rate on income over $400,000 from 37% to 39.6%.
- Moving the long-term capital gains tax rate from 20% to 39.6% for taxpayers with more than $1,000,000 in income.
- Reducing the combined federal exemption from $11,700,000 per person to as low as $3,500,000 with some proposals de-unifying the gift tax exemption to $1,000,000 per person.
- Increasing the top estate transfer tax rate to 55%, or even 77% for the ultra-wealthy.
- Eliminating the step-up in basis of property inherited at death and replacing it with a carry-over basis.
- Boosting the corporate tax rate from 21% to 28%.

Your Business

Mark Flinchum, a CPA and Partner with Katz, Sapper & Miller in Indianapolis specializes in strategic tax planning, business analysis and structuring and says there are steps business owners can take today in anticipation of the proposed tax policies. "Given that tax rates are likely to increase with any new tax legislation, deferring deductions to the tax year of higher tax rates and accelerating income, to the extent possible, into a lower tax rate year makes sense."

Another tax strategy Flinchum suggests is for business owners to examine their approach to depreciation. "If higher taxes are expected, electing out of bonus depreciation and writing off assets using the longer MACRS depreciation method class lives would potentially allow the taxpayer to spread depreciation deductions into tax years subject to a higher tax rate. Therefore, not electing out of bonus depreciation in a lower tax rate year could result in paying more tax if rates increase in a later year."

There are steps business owners can take today in anticipation of future tax increases.

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Your Employees

For over 50 years, cash value life insurance has been an efficient tool for businesses to informally fund compensation benefits to their key employees. Today, business owners expecting higher corporate tax rates who have been funding these benefits with taxable investments will see costs rise, leading to challenges in recruiting, rewarding and retaining their most valuable employees. Switching to life insurance as the funding asset not only can have a current positive impact on a corporate balance sheet via tax-deferred cash value growth and the ability to meet executive benefit liabilities through income tax-free withdrawals and policy loans but also to recover all benefit plan costs from the death benefit which can also be received by the company income tax free.

Your Wealth

Preparing their company for higher taxes is addressing only half of the picture and steps must be taken for business owners to protect what they have earned and their ability to grow it.

High-earning individuals facing increased taxation of investment income can use cash value life insurance to provide tax-efficient wealth accumulation and supplemental income via a policy's tax-deferred growth, income tax-free access to cash value via withdrawals up to cost basis and policy loans.

Your Estate

One technique to combat estate taxation is to make use of the federal estate tax exemption to significantly lower the value of a future estate. In 2021, each taxpayer is allowed to exempt $11.7 million from their estate either during their lifetime or at the time of their death. Therefore, gifting assets to an irrevocable trust, especially highly appreciating ones, today and having them grow outside of one's estate can result in major savings, especially when estate taxes could rise to as much as 77%.

In addition, there are strategies which involve the discounting in value of closely held business interests so that these interests can be gifted to a trust while utilizing as little of the federal estate tax exemption as possible.

SLAT Strategy

One recommendation estate planning attorneys are making to their clients who are preparing for higher taxes is the use of a Spousal Lifetime Access Trust ("SLAT"). "A SLAT permits married couples to utilize their estate tax exemption by each forming a trust to benefit the other and where some access to the assets in each SLAT is allowed," says John Olivieri, a Partner in the Indianapolis and New York offices of Barnes & Thornburg, LLP, whose practice focuses on estate and business succession planning.

Each spouse gifts up to their maximum exemption amount of up to $11.7 million to a SLAT for the benefit of the other spouse during that spouse's lifetime. Assets in each SLAT would not be included in either spouse's estate at death.

A problem arises with the death of either spouse when the surviving spouse is cut off from half of their combined trust contribution. This can be addressed by each SLAT purchasing a life insurance policy on the life of the other spouse. Then, when a spouse dies, the access cut off to a SLAT for the surviving spouse is offset by life insurance proceeds.

"Each SLAT would provide that after both spouses died, the remaining property in each SLAT will be divided into equal shares for their children," notes Olivieri.

Act Today

Higher taxes are likely coming soon and by taking a few, simple steps over the next several months to get ready, one's business and personal interests can be protected from any of the proposed tax policies.