SHOULD TAXPAYERS ACCELERATE CAPITAL GAINS ON ASSETS THEY WILL RETAIN?

TAX PLANNING IN ANTICIPATION OF RATE INCREASES

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On April 28, 2021, the White House released a tax proposal as part of the American Families Plan which would significantly increase the capital gains tax rate. The capital gains tax rate for households with more than $1 million of income would be increased from 20% to 39.6%, which would, including the 3.8% Net Investment Income Tax, result in a maximum federal rate of 43.4% for long-term capital gains. The highest combined state and federal long-term capital gains rate for residents of Nebraska would be more than 50%.

In addition to a proposed increase to the long-term capital gains rate, House Ways and Means Committee member Bill Pascrell, Jr. introduced H.R. 2286, and a Senate proposal, the Sensible Taxation and Equity Promotion (STEP) Act, would tax unrealized capital gains at death. Both bills would tax unrealized capital gains above $1 million at death and would be retroactively effective to Jan. 1, 2021.

While it is uncommon for tax legislation to retroactively increase federal tax rates, it has occurred before, most notably with the Tax Reform Act of 1993. It is premature to assume any of the recent proposals will become a part of legislation that is enacted into law, as these proposals will be subject to significant opposition and thus may never be enacted. If they are enacted, they will likely be modified. With these proposals, however, taxpayers with

significant capital gains in assets they desire to retain may wish to consider accelerating those gains to lock in the current capital gains rate and potentially owe a lower total tax liability.

Accelerating capital gains can be an effective strategy to hedge against a future increase in the capital gains tax rate. Yet taxpayers may have concerns about maintaining economic ownership of appreciated capital assets. This may be particularly important for capital assets like closely held stock or stock held by employees. The individual owners of these capital assets, however, may be able to both retain the capital asset (such as the closely held stock) and accelerate the unrealized capital gains in 2021. This may be able to be accomplished through certain planning techniques like an intentionally defective Section 351 transaction, which would accelerate the capital gains while allowing the taxpayer to retain economic ownership of the capital asset. This strategy may be particularly well suited for taxpayers who have sufficient liquidity to pay the tax without selling the asset and who plan to sell the appreciated capital asset in the relatively near future.

With respect to a change in the top long-term capital gains rate, if the American Families Plan figure of $1 million becomes a reality, accelerating existing capital gains should be considered. The proposal would nearly double the highest long-term capital gains rate for Nebraska residents from 30.64% to more than 50%! In light of this, taxpayers with high income or especially sizable capital gains may wish to accelerate the capital gains if only as a form of "tax insurance" to hedge against the risk of potentially dramatic increases in long-term capital gains rates.

Although the decision to accelerate capital gains based on less than perfect information is a complex and challenging decision, the additional proposals from the House and Senate calling for the elimination of the step-up in basis of capital assets upon death adds further complexity. If such proposals become law, holding appreciated assets until death would switch from a generally desirable tax strategy to a potentially undesirable one. Other accelerating income techniques to recognize capital gains such as electing out of the installment sale rules and forgoing like-kind exchanges should also be considered.

The capital gains rate increase and elimination of the step-up basis upon death are proposals and possibilities, but they may not be enacted. While in many cases, the right answer may not be definitively known today, not having a conversation about it at all is not a good alternative for proactive advisors and accountants seeking to reassure and inform clients. ◀

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