2021 Tax Planning: The Biden Tax Plan & More

Featuring Carole Foos, CPA

David Mandell:

Hello, I'm David Mandell, host of the podcast. Welcome. Today we're doing another special episode of the podcast, rather than interview a physician or an advisor, or expert out in the field. We're going to talk about a very timely topic. And my guest is an expert in the field, my partner, but before we bring her on, Carole Foos, I'm going to talk about a couple of items. All of these are extremely timely. As we record this, the second week of January, we now know that a president elect Biden will have both the House and the Senate controlled by the Democrats, which makes the likelihood of him being able to pass significant tax legislation much higher than it looked just a couple of weeks ago. And so we thought it was really important to get the word out to our listeners on what we think may be coming.

And that's really what Carole is going to come on and speak about, Biden's tax proposals and what they are and what planning you want to be thinking about around that as it develops -- and use that as a springboard about talking about taxes for 2021, in general. So what I'm going to do is talk for a couple of minutes on two topics that relate to income tax planning for 2021 and beyond that are extremely powerful, that don't really relate to any changes that Biden will be bringing. Then we'll bring Carole on to talk about the Biden proposals and what we can expect.

So, two things I want to talk about are, one actually is related to a legislative change, actually. The very last couple of days of 2020, the act that was passed, the Consolidated Appropriations Act, made a change that's very significant. I want to talk about that first. And then I'm going to talk about a timeless tax planning strategy that all of you should be implementing.

So first, the tax law change that we just had enacted benefits permanent life insurance. For those of you who listened to a couple of podcasts back where I had Jason on, you know that we talked about permanent life insurance, as opposed to term insurance. Certainly, we've got chapters in our book, Wealth Planning for the Modern Physician, on this, three chapters, the good, the bad, the ugly, the great and everything in between. I don't want to go down that rabbit hole.

But in general, at a high-level, permanent insurance is also known as cash value life insurance. There's a lot of different types. There's whole life. There's universal life. There's equity index. There's private placement, et cetera. One of the key benefits of that asset class is that it grows tax-free and if managed properly can be accessed tax-free. That makes it a very powerful tax diversification tool, because, for our clients who want to be able to pull tax-free money out in retirement, this is a great asset class.

In addition, the asset protection, which many of you who know me, know that's one of my areas of expertise, is at the highest level, what we call +5, an exempt asset, in about 20 states. In the other states, they can be owned by LLCs or trusts for very high-level of protection.

For physicians, the idea of growing assets tax-free, for being able to access them tax-free, to have ultimate or very high-asset protection, depending on the state, makes this asset class very attractive, not even mentioning how the assets grow.

In fact, what we often talk about is that you can see this kind of asset class as an unlimited Roth IRA. Most physicians, if you asked them, would want to put more money in a Roth IRA to take advantage of tax-free growth and tax-free access, but they're limited in how much you can put in. But you're not limited in permanent life insurance. So that's the background.

But even within permanent life insurance, when I say you're not limited, in fact, there's very specific tax laws that the insurance companies need to follow when they offer you a product. I've got a number of these cash value policies myself, so I know, based on your age and how much you're putting in and these corridors, they figure out how much you can put in in order to get those tax benefits. If you put in too much, it becomes what's called a Modified Endowment Contract, or MEC and then you don't get those tax benefits. Well … in the wee hours of 2020, the Consolidated Appropriations Act 2021 was adopted before the end of the year to keep the government going, to do some Corona virus relief, et cetera…. and this law impacted how much you can put into such policies.

On page 4,923 --- I didn't read that --this is coming from an industry expert I read, but I'll take it as true. Page 4,923, Section 205, which contained revisions to IRC, which means Internal Revenue Code Section 7702. Again, I don't want to dive into it, but 7702 basically covers what the government says is life insurance and all those tax benefits. It determines how those policies need to be structured, et cetera.

They made a change in this act passed in the last couple of days of 2020, that affects that 7702 statute and, particularly, the rate that life insurance companies need to use to structure their products. my partner, Jason O'Dell may do more webinars on the specifics, but the bottom line you need to know is that because of this change, what we thought was an excellent tool (and I have personally used an asset class for tax-free growth and tax-free access and asset protection), just got better.

They made a good tool, or a great tool, even greater. A good tool great, a great tool even greater, whatever you want to call it. From a growth and tax efficiency perspective, this change to that Section 7702 makes it even more attractive. We don't know all the effects. We're going to see how the insurance companies adopt it, but we can expect policies to be even more attractive than they have in the past. So again, one big takeaway as we come into 2021, if you have cash value life insurance, if you read our books, you know that you can exchange that into another policy. Maybe these new changes make it worthwhile to do that now. If you haven't used this asset class, but have thought about it or have been reading about it again, this may make things even more attractive in 2021 and beyond.

So that's concept number one.

Concept number two is what's called capital gain loss and gain harvesting. This is a concept that really gets into investing. It's something we do at OJM Group and have a really significant strength on that. When you have your investment portfolio, especially outside of qualified plans, you want to grow your assets, but you also should be aware of taxes. It's like that old Star Trek episode where it's not just chess, it's 3D chess. You want to be growing. That's the main thing. You want to be building wealth according to your plan, but you also want to be tax efficient. Part of that is gain and loss harvesting. I think the misconception that a lot of do-it-yourselfers have and a lot of advisors who don't really focus on this, is that this is job for the fourth quarter of the year. You wait to the fourth quarter.

You look at your portfolio or what's up, what's down? Did I have a carry-forward loss or carry-forward gain? Maybe I can do some tweaking in the fourth quarter to impact that and be efficient, sell something here, sell something there and then buy something similar and match up the gains and losses. But that's part of it and it is really not strategic harvesting. That should be done and be ready to be done at any time, because you just don't know when those opportunities are going to come.

Let's look at 2020. I'm going to give you a real example. The numbers are going to be a little hard to get. I'm certainly can send a slide on this, but we're going to use a real example of a physician client of ours.

At one point in late March of 2020, the S&P was down over 34% year-to-date. , as early as December 2019, we at OJM Group, on our Investment Committee, had already identified some funds within asset classes that we weren't so happy with, that maybe had some losses for our clients and were looking at other funds or options within those asset classes.

So a fund, let's say, within international or emerging markets. But we didn't want to really harvest those losses until we thought the time was right. We were already prepared to focus on a couple of different asset classes, and then we had the downturn in March come.

As a real example, on March 18th, 2020, we realized some losses for some clients. And this particular client, they had about $540,000 of a particular fund in international space. Now, we had purchased it a couple of years ago and it was down about a hundred thousand dollars or so. We purchased it around 650. We sold it around 550. We realized a total loss of about a hundred thousand in that position. On the next trading day, we took those proceeds and we put it in another fund, a different fund, but in the same asset class that we had targeted, we'd done our research and due diligence.

Well, as of me creating this slide with our investment team, which was late December 2020, so it's not in January 2021, but as of late December 2020, that position was up 59%. in late December, it was up to 870. Yet we still had a loss of over a hundred thousand dollars. This is the perfect situation for the client. Now their asset's up 60% from when we sold it. It's up significantly from when we bought it. But they have a hundred thousand dollar plus loss in their hip pocket that they can use if there are other gains or they can carry it forward.

We did the same thing in an emerging markets fund. One was developed international. This was in emerging markets. We had a fund that was at 620. We originally had bought it all the way back in '14. It had a loss. We sold it on the same day in March. We realized that loss, again, close to a hundred thousand dollars of loss. The next day we purchased another index fund or another fund within that asset class that we felt good about.

And again, as of late December, as I put this slide together, that fund, that position was up 77%.

So again, in these two places, we did very strategic loss harvesting to reinvest it. All the due diligence was done already. We weren't flying by the seat of our pants. We knew we wanted to go into. We pulled the trigger with confidence in mid-March. And not only were those clients up 60, 77% from when we bought it, and not only were they up significantly from even their original fund, but they had collectively about $200,000 in losses. Now, even if we didn't use those losses in 2020, those will be carried forward in future years. This is really strategic capital gain and loss harvesting. It's not just waiting to the end,

because if we waited until the end of the year, a lot of those positions that had losses were up, right? Obviously the funds we chose were up significantly, but even the funds we had before were up. So we would have lost that opportunity to create tax losses within the asset classes.
We were able to shift gears within the same asset class, harvest those losses, but still have significant growth in the portfolio. That's what you want. If you're not doing that, and very few people are doing it if they're doing it themselves, or if your advisor's not doing this actively, this is what you should be asking for. This is what you should be demanding from your advisors. And we'd love to chat with you about that.

So as we come into 2021, two things, cash value life insurance just got better, because of some tax law changes. And timely strategic capital gain loss harvesting should be something that's looked at throughout the year in 2021. Don't wait to the fourth quarter. Those are the two takeaways. Now, let's bring on my partner, Carole Foos, to talk about the Biden tax plan and what we can be expecting and potentially planning for in 2021.

So Carole is my partner, and also most importantly, she is my CPA, so I'm getting great advice. She is a certified public accountant and tax consultant to OJM Group clients, including physicians, professionals in their businesses. She is over 25 years of experience in accounting, tax planning and financial consulting. She was formerly a manager in the tax department of a big four firm and spent several years in public accounting and local firms. She's also coauthor of number of our books, including the namesake of this podcast, the book Wealth Planning for the Modern Physician, Wealth Management Made Simple and our CME piece, Risk Management for the Practicing Physician. She's also authored numerous articles and presented a ton of lectures, webcasts, podcasts on tax planning, wealth management, and other financial topics. So with that, Carole, welcome to the program.

Carole Foos:

Thank you, David.

David Mandell:

So, I just discussed a couple of ideas that I think are timely. Well, obviously one changed, benefited in the new law that was passed. The other is kind of timeless, something that people should be thinking about all the time. But as we sit here and record this the second week of January, we know now that Joe Biden will come into the presidency with both parts of Congress controlled by the Democrats. So now it looks much more likely than it had in the past that he might be able to get more of his tax agenda through legislation. And so I thought it was really important --and I know you do too-- to let people know at least what he's said he wants to do. Whether that ever all comes to pass or not we don't know, but at least it gets people thinking about what could happen and kind of the planning concepts that may come out of that. So why don't you kind of go where you want to go here in terms of what you think the most important elements of what Biden said he wants to do and what people should be thinking about?

Carole Foos:

Sure. That sounds great. So I think first and foremost, in terms of one of his proposals that will likely affect just about all of the listeners on here, if not today, then certainly probably in the near future is a return of the top individual tax rate from the current 37% to 39.6%, which is what it was prior to the Tax Cuts and Jobs Act that passed at the end of 2017. That 39.6% rate would apply to taxpayers with taxable income above $400,000. So again, I think that's going to affect many of our listeners.

David Mandell:

Sure.

Carole Foos:

Now, he really has not made clear where there's different filing statuses. So we don't really know what he's proposing in terms of is that 400,000 of taxable income, regardless of whether you're a single tax payer or you're married filing jointly, will there be some phase-in of that? That's not been made clear and obviously this is all up for negotiation with Congress. But that's going to be something that I think will most certainly be at the top of his agenda. And that rate was scheduled to revert back to 39.6% at the beginning of 2026 anyway, but the individual changes under the Tax Cuts and Jobs Act were temporary. So we're just probably looking at that happening four to five years sooner than it was already scheduled to happen.

Another important piece that he has proposed would be, again, this is for higher income taxpayers, but his proposal includes taxing long-term capital gains and qualified dividends at the same rate as ordinary income. Now this would be for those high-income taxpayers who have taxable income or income above a million dollars. So we're not talking about the $400,000 level, but presumably if your income is above a million dollars, rather than the current 20% long-term capital gains and dividends rate, you could be looking at a 39.6% rate. Now, right now we still have a 3.8% net investment income tax on capital gain income. So presumably that would still apply even if they're being taxed at that 39.6% rate under the new law. And I do think something to think about as you're planning with your personal CPA for our listeners, it's if this passes, it will be more important than ever to really plan for those capital gains, to do harvesting of capital losses against capital gains. And also, I think, one thing to think about is liquidity events for your business. Much of that income is typically taxed at long-term capital gains rates.

So I think we might look at longer term installment sales, where you're realizing that income from a sale of your practice or your surgery center over several years versus taking all the income in in one year if a 20% rate on capital gains versus a 39.6% rate.

David Mandell:

Yeah. I want to comment on. So first of all, yes, if that happens, obviously, we have some listeners and we have plenty of specialists who are over the million dollar income range. Obviously many docs who aren't, but for those who are, this sounds to me extremely significant. I mean, going back to 39.6, We knew that was coming anyway.

Regarding capital gains taxes, what I talked about in the beginning of this, that harvesting between losses and gains becomes absolutely crucial. Another concept is using qualified plans to reduce your income below the threshold in this case, a million.

And that if it's passed that way, and that takes you out of the higher capital gains, that's a really powerful, win-win. Not only are you reducing your income tax, but now you're putting yourself out of that kind of terrible capital gains tax situation.

Carole Foos:

Right. I think certainly you bring up a great point because when we're thinking about those qualified retirement plans, such as a cash balance plan or some other type of defined benefit plan, sometimes what has kept practice owners from implementing those plans is the cost of covering employees. Well, now, if you're looking at a, again, a doubling of your capital gains tax, it might make that cost of covering employees more palatable if that's what gets you a deduction that allows your income to be below that level.

David Mandell:

Absolutely.

Carole Foos:

So that's definitely going to be something to think about.

One of the other items in President-elect Biden's proposal that I think is significant to many of our listeners is currently, on wage income or self-employment income, we pay social security taxes up to a wage cap. For 2021, that wage cap is $137,700. And then, we don't pay any social security taxes after that. We pay Medicare taxes on all of our wages; it's unlimited. Well he has proposed having that wage cap, it would still stop, for instance, at the $137,700. But then, it would start up again on wages above $400,000. And that social security tax between the employee portion and the employer portion, it's a 12.4% tax.

Carole Foos:

Paid for half, 6.2% by the employee, 6.2% by the employer. So for many of our listeners, if you're the owner of a practice and you've got wage income from the practice, you're paying an additional 12.4% on any W-2 wages you take that are above $400,000 if this proposal is included in a new tax law.

In addition, for any of your employees, if you're employing other physicians or you're paying them more than $400,000, you're paying the employer portion, or 6.2%, on their wages above $400,000. This could be very significant dollars.

I think the other thing that comes into play when we're talking about this; so in our practice, we have a lot of physician clients whose practices are set up as S corporations. But what we often see with those clients is, they're S corporations but they're acting like a C corporation, meaning all of their income is paid to the owners through W-2 wages. That would mean it's all subject potentially to, certainly to Medicare taxes. And then, potentially again, a lot of it will be subject to these social security taxes. It's really going to be important if your practice is an S corporation and you're an owner to look at how you're compensating the owners and make sure you're paying reasonable wages via W-2 income, but that you're also doing profit distributions to the owners as those profit distributions are not subject to social security and Medicare taxes.

David Mandell:

Absolutely. We've seen that. You and I have seen that for 15 years or more at OJM Group, where we see S's acting like a C, where they're just paying out everything, even though they are very highly comped docs. And there's no bright line rule exactly on what is reasonable comp is. But I think we can confidently say we've seen many physicians who have S corps who are paying themselves certainly more than what's reasonable.

Carole Foos:

Right.

David Mandell:

Because there's different ways to get there. And you work with your CPA. And certainly, one of the benefits of OJM Group is, we get to see lots of physicians and their CPAs and how they approach it, whether it's, what would they have to hire somebody else at, or what does the MGMA data say, et cetera, there's some benchmark that they can use rather than just... I don't want to say being lazy and just putting it all as compensation.

Carole Foos:

Right.

And I think a lot of the pushback that we see from clients often is, unlike a partnership, if you're an S corporation owner, those distributions have to be pro-rata, based on your ownership percentage. But again, I think there are creative ways that you can structure compensation to meet that pro-rata distribution; for instance, the lowest percentage owner; but still get some benefits so that you're not overpaying yourselves in W-2 compensation.

David Mandell:

Yeah. And this also, I think, gets back to the discussion on qualified plans, meaning if we can reduce everybody's comp, if we have a better plan in there. Now again, it doesn't mean every practice is going to be a good candidate for a defined benefit plan or a cash balance plan, where deductions can be in the $100,000, $200,000, per participant. But there's probably, again, like you just said before, it's another potential benefit of that kind of plan if it's reducing comp. And those practices that haven't looked at it or looked at it in the past and said, "Well with the employee costs, it just doesn't make sense." Now this is another item on the pro side of it, not the con side.

Carole Foos:

Yes , and for some listeners, it might also be perhaps a non-qualified plan might also be a way to help alleviate some of this.

David Mandell:

Right.

Carole Foos:

So it's definitely worth looking at all the options and it's going to take some planning to help minimize what it's going to cost you.

David Mandell:

Yep. Makes sense.

Carole Foos:

I think one of the other things that, again, will affect probably most of the listeners will be a return of the Pease limitation, which limits itemized deductions. For those under the proposal, it would be people with taxable incomes above $400,000. Again, that $400,000, kind of the magic number for a lot of these.

The Pease limitation was in effect under previous tax law. Essentially, the way it worked was, if your income was above a certain level, your itemized deductions got reduced by about 3%. So it's a reduction in itemized deductions.

In addition to that, his proposal caps the tax benefit of itemized deductions to a maximum of 28%. Again, if you're earning more than that $400,000 number. So if you're above that threshold amount, essentially, any dollar of itemized deductions is only going to give you a $0.28 tax benefit, rather than, for instance, a 39.6% or $0.396 tax benefit.

David Mandell:

Interesting.

Carole Foos:

If they were fully deductible.

David Mandell:

So those are like charitable deductions too?

Carole Foos:

Yeah.

David Mandell:

Would that be under that?

Carole Foos:

Yes. Presumably.

David Mandell:

We don't know for sure, of course.

Carole Foos:

We don't know for sure. Right.

Carole Foos:

Now another thing that has been talked about; I don't think it's written in his proposal; but word on the street is he is in favor, as are Nancy Pelosi and Chuck Schumer, of getting rid of the cap for state and local income and property tax deductions. So under the Tax Cuts and Jobs Act, those got limited to a maximum deduction of $10,000, which really hurt a lot of taxpayers. But certainly, those in some of the higher tax States like New York, New Jersey, California, right?

David Mandell:

Absolutely.

Carole Foos:

We're seeing huge impact from the limits on the deductibility of those state and local income and property taxes. So that might go away, which would certainly help offset some of these other limits on itemized deductions, if that happens.

David Mandell:

For sure. Yeah, that would be a good win for a lot of our clients. Like you said, especially in the states where they have a state income tax.

Carole Foos:

Yes. Another thing he has proposed is a phaseout of the qualified business income deduction. So the 199A deduction for filers with taxable income above $400,000. Now many physicians are not able to take this deduction anyway, because of specified service trader business rules. However, some physicians are able to take it on surgery center income. Certainly, we have physician clients who are able to take it on some of their other investments that they've made into other businesses; maybe it's real estate investments or things like that. But one of the proposals would be for anyone with taxable income above $400,000 to not be able to take that deduction.

David Mandell:

Okay.

Carole Foos:

Now again, that's another deduction that's going away beginning in 2026 anyway, as the tax law's written today. And I guess, along those lines, while we're talking about the qualified business income deduction, we should also talk about, for listeners whose practices are taxed as a C corporation, he has proposed raising that 21% flat rate, which came into play with the 2017 Act, not up to the 35% that it used to be, but up to 28% flat rate.

David Mandell:

Okay.

Carole Foos:

So you would see an increase in that C corporation tax rate as well.

And then, I think one of the other things that, couple of other things that I would point out, the child and dependent care tax credit would be expanded. Currently, the maximum qualified expenses are $3,000 per child, $6,000 for more than one child, that you can then take a credit for childcare that you're paying. He's proposing expanding that to $8,000 per child or $6,000 for multiple children. Certainly, I think any of you who are paying childcare certainly pay more, well more than $3,000 or $6,000 for childcare. So that would be helpful.

And then, estate and gift taxation.

David Mandell:

Right.

Carole Foos:

Talking about restoring the rate and the exemption to the 2009 levels. So we're looking at potentially a $3.5 million federal and state tax exemption.

Now I guess the other thing I would say on that is, A: we don't know if this tax law is going to pass. We don't know in what form it will pass, right? These are President-elect Biden's proposals.

David Mandell:

Right.

Carole Foos:

It's going to get negotiated through both houses of Congress. Who knows what it will end up being.

That being said, we also don't know, in my 30-year career of being a CPA, sometimes tax laws pass with a retroactive date. Sometimes they pass and they're effective at a date in the future, like January 1st of the next year. Certain aspects of them often even are pushed farther out than that. But if you are in a position where you're thinking about estate planning and you're thinking that you might have a taxable estate larger than what you're looking at in the current estate tax exemption, I would tell you that now that we know Congress, both houses of Congress, are under democratic rule, the President-elect is a democrat, these are his proposals, there's certainly a likelihood that some form of this will pass. So it's a great time to get with your estate planning advisors to talk about, "Is it a time to gift? Is it a time to look at some estate planning tools?" To make sure you're protected on that front.

David Mandell:

Yeah. And that reminds me of the podcast, which hopefully, a lot of people listened to that we did with Jason before the end of the year. And the topic there was taking advantage of today's low interest rates. And one of the concepts of the four that we went through was estate planning using those intrafamily loans, which gives you flexibility.

So if you're in the position where you say, "Hey, listen. I'm certainly now at an estate-taxable position, even with the exemptions as they are today," then you're going to have a real high estate tax liability, potentially, if the rules change. And even if you don't have one today, but you look at your growth rate of your assets and you're going to be there, we know. Because the rules have changed so many times as far as we've been practicing that these things change. And people want flexibility and the ability to use these low interest rates to make a loan to a trust or to an LLC or something. And then, decide in the future, "Am I going to collect on that loan? Am I going to forgive it?"

The ability to do estate planning with the low interest rates gives some flexibility. So if people get motivated because this new rule comes in, but they're still relatively young; they're not in their eighties or nineties and they've got a lot of time; there's a way to, I'd say, have your cake and eat it, too. But at least make some planning but not be locked in. And sometimes, that involves loans. And there's no better time to be doing that than today with the rates the way they are.

Carole Foos:

Right.

David Mandell:

So Carole, that was really helpful. Obviously, there is a lot here. There's items that you talked about that impact income, capital gains, gift to state tax. It's pretty much everything.

Carole Foos:

Right.

David Mandell:

But we don't know where it's going to be. But I think, for the listeners, being aware of what has been proposed, keeping an eye on it, obviously at OJM Group, as things happen and laws get passed or proposals are more definite, you'll be hearing from Carole and myself in various forms, in our newsletter, in our internal OJM podcast, in our webinars. And I think one of the big messages is to plan. And the ideas that I discussed before you even came on, that's always the case.

Carole Foos:

Right.

David Mandell:

And with these new proposals, even more so. Any last words?

Carole Foos:

No. I think that's exactly it. Keep an eye on it. Plan. Knowing what's proposed, I think it's a great time to be talking to your advisors about, "What are some things that I can do, should this pass?" And some of the things you might want to do, regardless of whether it passes or not.

David Mandell:

Right.

Carole Foos:

Just because it makes a better business decision, better tax-planning decisions.

David Mandell:

Absolutely. So thank you, Carole, for being on. And thanks to all the listeners. We will keep you informed as this developing story continues. So I look forward to having you on and listening to the next podcast. Thank you, all.

Carole Foos:

Thank you.