Washington State and Federal Tax Update

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DISCUSSION OVERVIEW

- Washington State Capital Gains Tax
- Washington State Long-Term Care Tax
- Federal Tax Update – A Look Ahead

Washington State Capital Gains Tax

WASHINGTON STATE CAPITAL GAINS TAX

- ESSB 5096 – Passed by 2021 Washington State Legislature
- Enacted as RCW 82.87
- Imposes 7% tax on the sale or exchange of long-term capital assets
- On profits exceeding $250,000 annually
- Applies to Individuals
- Washington State gains
- Tax effect January 1, 2022
- Revenue collected to fund education legacy trust account and common school construction account

CAPITAL GAINS TAX – RCW 82.87.100, INTENT

- Washington's tax system is “the most regressive in the nation”
- Middle-income families pay two to four times more taxes, as a percentage, than top earners
- Low-income families pay six times

CAPITAL GAINS TAX – RCW 82.87.020, DEFINITIONS

- “Adjusted Capital Gain” means federal net long-term capital gain (each to the extent included in calculating federal net long-term capital gain):
  - Plus any exempt long-term capital loss
  - Plus any long-term capital loss not allocated to WA
  - Plus any amount of loss carryforward not allocated to WA
  - Less any amount of long-term capital gain not allocated to WA
  - Less any amount of long-term capital gain exempt from this tax
- “Capital Gain” or “Loss” means gain or loss on sale or exchange of a long-term capital asset
- “Long-Term Capital Asset” means a capital asset held for more than one year

CAPITAL GAINS TAX – RCW 82.87.020, DEFINITIONS CONT.

- “Capital Asset” has the same meaning as Code Section 1221
- “Federal Net Long-Term Capital Gain” is as determined under the Code, but as if Sections 55-59, 1400Z-1, and 1400Z-2 did not exist
- “Taxpayer” means an individual
- “Individual” means a natural person

CAPITAL GAINS TAX – RCW 82.87.020, DEFINITIONS CONT.

- "Resident" means an individual:
  - Who is domiciled in the state during the taxable year, unless the individual:
    - – Maintained no permanent place of abode in WA during the entire taxable year; OR
    - – Maintained a permanent place of abode outside WA during the entire taxable year; OR
    - – Spent in the aggregate not more than 30 days of the taxable year in WA

    OR
  - Who is not domiciled in WA during the taxable year, but maintained a place of abode and was physically present in WA for more than 183 days during the taxable year

CAPITAL GAINS TAX – RCW 82.87.040, TAX IMPOSED

- An "excise" tax is imposed on the sale or exchange of long-term capital assets
- 7% tax
- No carryover or carryback
- Tax applies when long-term capital gains are recognized by the taxpayer

CAPITAL GAINS TAX – RCW 82.87.040, TAX IMPOSED

- Beneficial owner: look for pass-throughs and disregarded entities, such as partnerships, S corporations, and grantor trusts
- Grantor trusts: a “nongrantor trust” is deemed to be a grantor trust if the trust does not qualify as a grantor trust for federal purposes, and the grantor’s transfer to the trust is treated as an incomplete gift under Code Section 2511

CAPITAL GAINS TAX – RCW 82.87.050, EXEMPTIONS

- Real estate
- Interest in a privately held entity only to the extent any long-term capital gain/loss is directly attributable to the entity's real estate:
  - FMV of the property minus the entity's basis multiplied by the individual's ownership percentage of the entity
  - Same result even if Code Section 751 applies
  - Real estate not owned directly by the entity is not exempt
  - FMV: DOR not bound by the agreement of the parties
  - Value of exemption may not exceed the individual's long-term capital gain/loss from the sale or exchange of the interest in the entity

CAPITAL GAINS TAX – RCW 82.87.050, EXEMPTIONS CONT.

- Retirement savings
- Condemnation proceeds
- Code Section 167(a)(1) and 179 property
- Timber, timberland, and dividends/distributions from REITs (to the extent derived from the sale or exchange of timber or timberlands)
- Commercial fishing privileges
- Goodwill from the sale of an auto dealership

CAPITAL GAINS TAX – RCW 82.87.060, DEDUCTIONS

- A standard deduction in the amount of $250,000 (individual, spouses, and domestic partners – even if separate returns)
- Any amount WA is prohibited from taxing under an applicable constitution
- Amount of adjusted capital gain from sale or transfer of the taxpayer's interest in a qualified family-owned small business (RCW 82.87.070)
- Charitable donations deductible under RCW 82.87.080

CAPITAL GAINS TAX – RCW 82.87.070, QUALIFIED FAMILY-OWNED SMALL BUSINESS DEDUCTION

- Provides deduction for capital gain derived from sale of substantially all of the FMV of the assets of or the transfer of substantially all of the individual's interest
- "Qualified family-owned small business" means a business:
  - In which the individual held a qualifying interest for at least five years; and
  - In which either the taxpayer or the taxpayer's family, or both, materially participated in operating the business for at least ten years; and
  - That had worldwide gross revenue of $10M or less (as adjusted for inflation) in the 12-month period preceding the sale or transfer

CAPITAL GAINS TAX – RCW 82.87.070, QUALIFIED FAMILY-OWNED SMALL BUSINESS DEDUCTION

- "Qualifying Interest" means:
  - An interest as a sole proprietorship
  - An interest in a business if
    - 50% of the business is owned, directly or indirectly, by any combination of the taxpayer or members of the taxpayer's family, or both
    - 30% of the business is owned, directly or indirectly, by any combination of the taxpayer or members of the taxpayer's family, or both, and at least:
      - 70% by members of two families; OR
      - 90% by members of three families

CAPITAL GAINS TAX – RCW 82.87.070, QUALIFIED FAMILY-OWNED SMALL BUSINESS DEDUCTION

- "Assets" means real property and personal tangible and intangible property
- "Materially participate" means involvement in the operation of a business that is regular, continuous, and substantial; and interpreted consistently with Code Section 469
- "Substantially all" means at least 90%

CAPITAL GAINS TAX – RCW 82.87.080, CHARITABLE DONATION DEDUCTION

- In excess of $250,000 (as adjusted for inflation)
- Deduction may not exceed $100,000 for the taxable year (as adjusted for inflation)
- No carryforward or carryback
- Must be a Code Section 501(c)(3) organization
- Code Section 170(c) is applicable
- Must be principally directed or managed within WA

CAPITAL GAINS TAX – RCW 82.87.110, ALLOCATION

- Tangible personal property gains allocated to WA if:
  - Property located in WA
  - Property not located in WA if:
    - Property was located in WA at any time during the taxable year or the immediately proceeding taxable year; AND
    - The taxpayer was a resident at the time the sale or exchange occurred; AND
    - The taxpayer is not subject to the payment of similar taxes in another jurisdiction
- A credit is allowed to the extent a taxpayer pays a tax to another jurisdiction

CAPITAL GAINS TAX – RCW 82.87.110, RETURNS

CAPITAL GAINS TAX – RCW 82.87.030, FOLLOW THE MONEY

- The first $500M (as adjusted for inflation) collected each fiscal year is deposited in the education legacy trust account
- Any remainder is deposited in the common school construction account

CAPITAL GAINS TAX – OTHER PROVISIONS

- RCW 82.87.090: this tax is in addition to any other taxes of the state or its subdivisions
- RCW 82.87.120: joint and several liability; Code Section 6015 relief may apply
- RCW 82.87.140: criminal penalties may apply

CAPITAL GAINS TAX – COURT CHALLENGES

- *Quinn/Clayton, et al v. State of Washington*
- September 10, 2021, Ruling from Hon. Brian Huber
- Court denies Government's motions to dismiss
- Matter will proceed to the merits

Washington State Long-Term Care Tax

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LONG-TERM CARE TAX – BASICS

- Washington State has passed a new law mandating long-term care (LTC) benefits for Washington residents and employees
- Beginning January 1, 2022, Washington employees (not employees) will fund this program via a payroll tax
- Currently set at $0.58 per $100 in wages
- For every $10,000 in wages made, $58.00 in taxes will be paid
- No guarantee that the state will not raise this rate in the future

LONG-TERM CARE TAX – WHO PAYS THE TAX?

- Employees who work in Washington for all or part of the work week
- All wages earned in Washington are subject to the tax
- Self employed individuals (K-1), employees of federally recognized tribes, and some union members are exempt from this tax
- Unlike other taxes, no cap is placed on the amount of wages that are taxed

LONG-TERM CARE TAX – WHAT IS THE BENEFIT?

- In general, beginning January 1, 2025, “qualified employees” can receive up to $100 per day in long term care benefits, up to a lifetime maximum of $36,500
- “Qualified employees” are defined as:
  - Individuals who have paid premiums under the program for a total of 10 years without interruption of five or more consecutive years; OR
  - Individuals who have paid premiums for three of the last six years from the date of the application for benefits; and worked at least 500 hours during each of the 10- or three-year timeframes

LONG-TERM CARE TAX – HOW TO OPT OUT?

- Employees have a small window to opt-out or receive an exception from paying the tax if they attest to having sufficient LTC insurance purchased prior to November 1, 2021
- The Employment Security Department (“ESD”) will accept applications to opt-out only between October 1, 2021, and December 31, 2022
- Policies must be obtained by October 31, 2021, to qualify for the exception
- ESD has not yet provided guidance on how to opt-out

LONG-TERM CARE TAX – CONSIDERATIONS

- Benefit maximums are a fraction of actual costs
- No benefit available to individuals who move out of state
- Likely no benefit if you will retire within the next five years
- Likelihood the tax will increase
- Once you opt-out, you cannot opt back in
- Significant unknowns exist regarding how this tax and benefit will look in the future

Federal Tax Update

FIVE THINGS TO DISCUSS

- Where we are now
  - Current Tax Law
- Where are we going?
  - President Biden's Tax Proposals
  - Other Potential Changes
- How will we get "there"?
  - Budget Reconciliation
- What will it look like?
  - Current Uncertainty
  - Effect on current estate planning tools
- What to do now?
  - Advise affected clients of risks and options
  - Options for gifting as appropriate
  - How to talk to our clients

CURRENT LAW

2017 TAX CUTS AND JOBS ACT

- Achieved via Budget Reconciliation
- Numerous Significant Changes
  - Corporate Income Tax rate reduced from 35% to 21%
  - Creation of § 199A Qualified Business Deduction
  - Doubling of Estate Tax exemption
  - Reduced Rates for Individual Income Tax Brackets
  - Increased Standard Deduction while eliminating Personal Exemption
  - Elimination/reduction of many long-time deductions
- Many Changes Temporary
  - To comply with Budget Reconciliation Rules many changes “sunset” on January 1, 2026
  - Notably the Corporate Income Tax rate does not sunset
- Significant Tax Cut for High Earners and Businesses
- Significant Cost
  - Trump Administration predicted tax cuts and budget would boost revenue to offset losses from tax cuts
  - Joint Committee on Taxation initially predicted a $1.5 Trillion deficit increase over ten years, later updated to first $1.9 Trillion and more recently $2.3 Trillion, partially offset by a boost in economic activity of $385 Billion

CURRENT LAW

INCOME TAX

- Individual
  - Seven Brackets: 10%, 12%, 22%, 24%, 32%, 35% and 37%
  - Top Rate Threshold: $523,600 single / $628,300 MFJ
  - Standard Deduction: $12,550 / $25,100
  - Limited State and Local Tax Deduction: $10,000
  - Capital Gains: 15% and 20%
  - Pass-through Entities: 20% deduction for “Qualified Business Income”, deduction limited for “specific service trade or business”
  - Net Investment Income Tax: 3.8% of lesser of (a) taxpayer’s net investment income or (b) the amount their modified adjusted gross income exceeds $200,000 ($250,000 married filing jointly)

CURRENT LAW

ESTATE, GIFT, GENERATION SKIPPING TRANSFER TAXES

- Estate Tax
  - Rate: 40%
  - Exemption: $11.7 Million (during life + at death, portable)
  - Capital Assets: Basis "step-up" at Death eliminates gain
- Gift Tax
  - Rate: 40%
  - Exemption: $11.7 Million (during life + at death, portable)
- Generation Skipping Transfer Tax
  - Rate: 40%
  - Exemption: $11.7 Million

CURRENT LAW

OTHER NOTABLE TAXES AND PROVISIONS

- Corporate Income Tax
  - Rate: 21%
- Social Security
  - Rate: 12.4% payroll tax, split between employers and employees
  - Phase Out: $137,700

OTHER FACTORS

COVID-19

- CARES, HEROES and the CAA
  - Temporary Provisions: Recovery rebates, subsidies and grants to business owners, various tax credits, etc
  - Permanent Provisions: The CAA has made certain temporary provisions permanent
- FUTURE LEGISLATION
  - Aid to individuals, small businesses, and the States: President Biden and Democratic leaders have indicated their intention to pass additional legislation. Discussions are ongoing

WHERE WE MAY BE HEADED

INDIVIDUAL INCOME TAX

- Tax Increases on Income over $400,000
  - Restore 39.6% Top Rate
  - Expand Social Security Tax: 12.4% of earned income over $400,000 split between employer and employee
  - Itemized Deduction Tax Benefit Limited to 28%
  - Restore the 3% PEASE limitation: Reduces itemized deductions by 3% of AGI over $400,000
  - Add phaseout to 199A: would reduce application of 20% deduction for "Qualified Business Income" for non-SSTB

WHERE ARE WE GOING

INDIVIDUAL INCOME TAX

- Other Changes
  - 39.6% Rate for Capital Gains over $1 Million
  - Increase Child and Dependent Care Tax Credit
  - Expand EITC for childless workers aged 65+
  - Reestablish first time home buyers tax credit
  - Return of SALT deduction(Pelosi, Schumer)?
  - Mark-to-Market for capital assets (Wyden)?

WHERE ARE WE GOING

ESTATE AND GIFT TAX

- Restore 2009 levels
  - $3.5 Million Estate Tax Exemption, unindexed but portable
  - $1 Million Gift Tax Exemption, unindexed but portable
  - 45% Rate

- Eliminate Basis Step-Up
  - Unclear how this would work
  - Carry-over Basis vs. Unrealized Appreciation taxed at death

- Return of the § 2704 Proposed Regulations
  - IRS published proposed regulations in 2016 limiting valuation discounts for closely held businesses
  - Withdrawn due to President Trump's Executive Order limiting new regulations
  - Was a priority of the Obama Administration
  - Would be easy to republish

WHERE ARE WE GOING

OTHER PROPOSED TAX CHANGES

- Corporate Income Tax
  - Increase rate to 28%
  - Create a minimum tax on corporations with book profits of $100 Million
  - Double rate on Global Intangible Low Tax Income ("GILTI") earned by foreign subsidiaries
- Miscellaneous
  - Completely eliminate § 1031 (Like-Kind Exchanges)
  - Create Renter's Tax Credit aimed at holding rent and utilities at 30% of monthly income
  - Create and expand several renewable energy/green tax related credits
  - Eliminate subsidies for fossil fuels
  - Student Loan Debt Forgiveness
- For the 99.8% Act – Bernie Sanders' annual tax proposal
  - Quadruple the special use valuation cap to protect family farms and businesses
  - Value non-business assets held in entities as if owned outright
  - Require GRAT terms of at least 10 years and remainders of at least 25% of assets transferred to GRAT
  - Treat grantor trusts as owned by grantor for gift and estate tax purposes (distributions from trust = gifts by grantor; include trust assets in grantor's estate)
  - Deny allocations of GST exemption to trusts that may last longer than 50 years

HOW MIGHT WE GET "THERE"?

BUDGET RECONCILIATION

- Democrats don't have filibuster-proof 60 votes in the Senate
- Can use Budget Reconciliation instead, requires 51 votes for spending, tax and debt limit bills
- Democrats have 50 votes, Vice President Harris will cast a vote if there is a tie
- Budget Reconciliation used to pass 2017 Tax Cuts and Jobs Act to avoid filibuster, also used to pass 2001 Tax Act with Vice President Cheney casting deciding vote in the Senate
- Budget Reconciliation process:
  - House and Senate must pass concurrent Budget Resolution with instructions to committees to change spending or revenue amounts
  - Must then pass reconciliation bills that adhere to the instructions
- Two opportunities for reconciliation in 2021
  - Currently for 2021 fiscal year budget: Within first 100 days of new administration, likely to be used for additional COVID related legislation
  - 2022 budget: Usually passed in Spring, reconciled in Fall

LIMITS ON BUDGET RECONCILIATION

BYRD RULE

- Prohibits extraneous matters from budget reconciliation bills and requires 60 votes in the Senate to waive. Applies to provisions that:
  - Do not create a change in spending or revenue
  - Create changes in spending or revenue that are merely incidental to non-budgetary elements of the provision
  - Are outside the jurisdiction of the committee that submitted the provision for inclusion in the reconciliation measure
  - Increase spending or reduce revenue if overall the provision does not meet the instructions given to the reporting committee
  - Increase net spending or reduce revenue during a fiscal year after the years covered by the reconciliation bill unless the provision as a whole remains budget neutral
  - Contains recommendations regarding Social Security trust funds
- Consequence of limitations
  - Need to create "sunset" to avoid provisions that worsen the financial position of the government beyond the 5 or 10 year period covered by the bill – see both the Tax Act of 2001 and the Tax Cuts and Jobs Act of 2017
  - Remember, the Affordable Care Act could not be completely repealed via Reconciliation

LIMITS ON BUDGET RECONCILIATION

POTENTIAL EXAMPLES

- Many high profile Democratic proposals cannot be enacted using Budget Reconciliation:
  - Minimum wage legislation
  - Changes to the Voting Rights Act
  - DC or Puerto Rico Statehood
  - Gerrymandering reform
- But Budget Reconciliation could be used for proposals that may not be obvious:
  - Paid parental and sick leave
  - Housing vouchers
  - Clean energy investment
  - Expanded health care coverage
  - Free community college
  - Child allowance

EFFECTIVE DATE

RETROACTIVE CHANGES

- Tax legislation, even through budget reconciliation, may be effective immediately, at a point in the future or even retroactively:
  - The U.S. Supreme Court has repeatedly upheld retroactive tax legislation against due process challenges
  - The standard is the law must be rationally related to a legitimate legislative purpose
  - See *Pension Benefit Guaranty Corporation v. R.A. Gray & Co.,* 467 *U.S.* 717 (1984); *U.S. v. Carlton*, 512 U.S. 26 (1994)
- Consequences/Complications of retroactivity
  - Changes to taxation of prior gifts
  - How to deal with a completed § 1031 exchange where now no longer tax-deferred

EXEMPTION REDUCTION CONSEQUENCES

- IRS guidance clarifying no "clawback" if gift at higher exemption then die with lower exemption
- However, IRS and industry guidance indicate that the amount of exemption when a taxpayer dies will likely first be applied to prior lifetime gifting. So if made gifts of $5 Million in 2020, and die in year when exemption is $3.5 Million, we apply the $3.5 Million to the prior gifting and "use it up", there's no clawback for the $1.5 Million difference, every dollar in the taxpayer's estate will be subject to estate tax and the taxpayer will have "lost" use of $6.4 Million of exemption

WHAT MIGHT THE FUTURE LOOK LIKE?

MUCH UNCERTAINTY STILL

- Clear Democratic consensus to increase income tax on highest earners and expand Estate Tax, unclear what form this will take
- What about the Gift Tax? What about GST Tax?
- Proposed §2704 Treasury Regulations
- What about basis?

WHAT TO DO NOW

DEPENDS ON CLIENT'S SITUATION

- Use it or Lose it vs. concern of giving too much away
  - Need to make sure client is comfortable
  - Need to be deliberate and realistic in making recommendations: "First, do no harm"

- Practitioners should be cautious dealing with clients who will potentially lose exemption
  - Model/forecast planning scenarios
  - Apprise client of risks
  - Offer options
  - Have lien, judgment, credit report and any other due diligence completed
  - Have client execute letter affirming understanding of risks whether client decides to plan or not
  - Build in flexibility

- Estate Plan in place
  - Review current plan
  - Options for modifying

UPDATING ESTATE PLANS

OPTIONS FOR MODIFYING PLANS

- Some items may not be affected/able to be changed
  - Installment Note Sales
  - GRATs
- New documents
  - Amending & Restating Trusts
  - Wills
  - Powers of Attorney
- Modifying Irrevocable Trusts
  - Authority of Trustee or Trust Protector
  - TEDRA
- Lack of capacity
  - Power of Attorney
  - TEDRA

WHAT TO TELL OUR CLIENTS

- Education
  - Need to review their net worth, assets and plan
  - How new laws may affect their plan and potential tax implications
  - Options for using current exemption and provisions designed to avoid making a current taxable gift in excess of exemption
  - Taxes not only reason to plan:
    - Asset protection
    - Control over assets
    - Family dynamics
    - Potential protection against elder financial abuse

QUESTIONS AND COMMENTS?