THE CATHOLIC FOUNDATION

The American Families Plan: Biden's Called Shot...or Not?

In This Issue:

- The American Familes Plan
  - Income Tax
  - Capital Gains Tax
  - Step-Up in Basis
- The Accelerating Charitable Efforts Act

The American Families Plan: Biden's Called Shot...or Not?

Babe Ruth stood out for his talent and showmanship, even on a Yankees team with eight other future Hall of Famers. Ruth set hitting records and inspired legends—especially his "called shot" in the 1932 World Series against the Chicago Cubs.[1] The score was 4-4 in the fifth inning. In response to heckling from the Cubs players, Ruth stepped up to the plate and pointed to center field with a boldness that defied baseball's unwritten rules of decorum. Even for the Babe, hitting a homer was no sure thing. However, in this case, a legend was born, as Ruth did indeed blast the ball out to the deepest part of the stadium for a home run and the Yankees went on to win the World Series.

Unlike Babe Ruth, candidates running for office are typically vague when indicating what they plan to do. However, during the 2020 election campaign, Joe Biden boldly announced that if he won, he would enact tax policies that resulted in "the rich" paying more. After a hotly contested election, Biden took office in January 2021 and, much like Ruth's called shot, began to issue executive orders and pass legislation to further his stated agenda. In direct opposition to President Trump's tax cuts from the Tax Cuts and Jobs Act of 2017, the Biden Administration released details of the American Families Plan.

Although this legislation still needs to pass Congress, in this issue of ***The Good Advisor***, we look at the potential increases to both income and capital gains taxes that this legislation could bring, along with the possible elimination of the step-up in basis, and how these changes might impact charitable giving. We also examine how the proposed Accelerating Charitable Efforts Act could affect donor-advised funds.

The American Families Plan

The American Families Plan (AFP) is a $1.8 trillion spending proposal that features $1 trillion in stimulus spending and $800 billion in tax cuts that benefit lower and middle-income workers and families through permanent and expanded credits and closing or reducing tax loopholes.[2] According to the Administration, the overarching goal is for the bill to be largely deficit-neutral. This means it won't result in any additional federal government spending despite the hefty price tag, since spending will be funded by substantially increasing taxes on households making over $1 million along with households in the highest income tax bracket. Theoretically, the American Families Plan budget will be fully paid for over 10 years by increasing both income and long-term capital gains taxes.

Of course, as this tax plan makes its way through Congress, it is sure to be challenged in both chambers by Republicans strongly defending the Trump tax cuts and Democrats who believe the plan does not go far enough. However, while we wait to see what the final version may contain, it is important to look at key aspects of the AFP and begin considering how these changes might impact clients and their philanthropic plans.

Income Tax

In 2017, the Trump administration introduced the Tax Cuts and Jobs Act (TCJA), which significantly reformed the Internal Revenue Code (IRC). From an individual income tax perspective, the TCJA kept the same number of tax brackets but lowered the rates and widened the ranges for tax years 2018 – 2025.

Under the proposed AFP, the highest tax bracket will return to the pre-TCJA 39.6% from the current 37%. These taxpayers would pay the increased rate:

- Single taxpayers (and head of household) with incomes over $518,400
- Married filing jointly with incomes over $622,050
- Married filing separately with incomes over $311,025

DONOR IMPACT

Taxpayers who are just within the income range of this bracket may feel the impact of the additional 2.6% more during this COVID-affected economy than they would have during an economic boom. This combination (a slightly greater tax burden and an uncertain economy) may cause donors to feel hesitant about continuing with certain

planned gifts or making new gifts. Affected donors may appreciate an exploration of charitable giving tools that can provide future income.

Capital Gains Tax

The TCJA did not change the capital gains tax rate or the net investment income tax (NIIT) rate. It did, though, change the brackets for capital gains, so that the top 20% rate no longer lines up with the top income tax bracket, but instead has its own threshold that falls in the middle of the 35% bracket.

Long-term capital gains rates for 2021 are:

Tax Rate	Single	Married Filing Jointly	Head of Household	Married Filing Separately
0%	Up to $40,400	Up to $80,800	Up to $54,100	Up to $40,400
15%	$40,401 - $445,850	$80,801 - $501,600	$54,101 - $473,750	$40,401 - $250,800
20%	Over $445,850	Over $501,600	Over $473,750	Over $250,800

The proposed increase to the capital gains tax is even more significant than the proposed increase to the income tax. If the AFP passes successfully, the top tax rate for long-term capital gains will increase from 20% to 39.6% for those making $1 million or more. According to the White House, this increase will only affect around 500,000 households.

It is important to note that the AFP does not include any change or adjustment to the net investment income tax created in the Health Care and Education Reconciliation Act of 2010.[3] The NIIT is typically associated with items of passive income in three categories:

1. Gross income from interest, dividends, capital gains, non-qualified annuities, royalties, and rents—income that is not derived in the ordinary course of a trade or business
2. Gross income derived from a business that is either a passive activity (within the meaning of IRC §469) or a business that trades in financial instruments or commodities as defined in IRC §475(e)(2)
3. Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a business that is neither a passive activity nor trades in financial instruments or commodities

When adding the NIIT to the proposed AFP's increased capital gains rate, taxpayers with income over $1 million face a maximum capital gains tax rate of 43.4%.

DONOR IMPACT

If the AFP increases the tax on long-term capital gains, it may make long-term capital gain property an even more desirable option for charitable giving. Typically, these gifts are simple to make, with the donor transferring possession of the asset to the charity using any document of title. The gift is deductible at fair market value (FMV) up to 30% of adjusted gross income (depending on the donee), with a five-year carryover of any excess deduction. Because the donor does not owe any capital gains tax on appreciation, significantly appreciated property is a tax-wise giving choice that may allow for a more substantial gift.

Example: Michael owns appreciated property with a fair market value of $5,000—property he purchased years ago for $1,000.

If Michael sold the property and donated the cash, he would have to pay a capital gains tax of approximately $800 (a gain of $4,000 taxed at 20%) plus the net investment income tax of $152 (3.8% on capital gains for taxpayers with MAGI above $200,000 or $250,000 for joint filers). The cash donation would be $4,048—well short of the property's $5,000 FMV.

However, if Michael makes a gift of the appreciated property, the qualified charity receives property worth the full $5,000, and Michael's net cost of making that charitable donation is far less:

Gift amount (FMV of property)	$5,000
Tax savings from the charitable income tax deduction (assuming a 37% income tax bracket)	($1,850)
Tax savings (capital gains tax + NIIT)	($952)
Net Cost of Gift	$2,198

An increase in the highest income tax bracket would increase Michael's charitable deduction, and an increase in the capital gains tax (if it applied to Michael) would result in greater tax savings for his gift.

Step-Up in Basis

One of the more unexpected changes in the proposed AFP is the elimination of stepped-up basis for larger capital gains. If enacted, this could have a significant impact on donors with larger estates. To better understand the potential challenges and opportunities, it may help to briefly review the step-up in basis.

Under IRC §1221, most of a taxpayer's assets will fall into the category of capital assets, with the following exceptions:

- stock in trade of the taxpayer (inventory or resale property)
- real property or depreciable property used in trade or business
- certain copyrights, compositions (literary, musical, or artistic), letters or memoranda, or similar property, held by the creator/owner or someone whose basis is based upon the creator's basis
- business accounts or notes receivable
- certain publications of the United States Government held by certain taxpayers (a situation few taxpayers will be in)
- any commodities derivative financial instrument held by a commodities derivatives dealer (except those clearly identified as an asset with no connection to the activities of such dealer as a dealer)
- any clearly identified hedging transactions
- supplies of a type regularly used or consumed by the taxpayer in the ordinary course of the taxpayer's trade or business

Generally, basis is the amount of the taxpayer's investment in the property, although this amount can be adjusted (increased due to improvements, for example, or decreased due to depreciation or a casualty loss). When the taxpayer disposes of the property, a capital gain is generally defined as the amount by which the selling price exceeds the adjusted basis (often the purchase price, but, as just mentioned, the basis can change over time).[4] IRC §1222 divides capital gains into short-term (for assets held one year or less) and long-term (for assets held longer than one year), with the holding period beginning the day after the acquisition. A long-term gain asset is subject to capital gains tax under the IRC.[5]

The "step-up in basis" is related to the valuation of an appreciated capital asset that passes at the owner's death. The IRC allows the taxpayer to value the inherited property at its FMV as determined on the prior owner's date of death.[6] Note the key language in IRC §1410(a)(1):[7]

> *(a) In general*
>
> *Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be—*

> *(1) the fair market value of the property at the date of the decedent's death,*
>
> *(2) in the case of an election under section 2032, its value at the applicable valuation date prescribed by such section,*
>
> *(3) in the case of an election under section 2032A, its value determined under such section, or*
>
> *(4) to the extent of the applicability of the exclusion described in section 2031(c), the basis in the hands of the decedent.*

The step-up in basis is an obvious tax benefit, as the person inheriting the appreciated property avoids capital gains tax on the appreciation. Let's look at an example.

Jonathan purchased a piece of land for $10,000 that he held as an investment—land that steadily increased in value even though Jonathan did not make any improvements to the property. Jonathan didn't have any children but was close with his only niece, Martha, and planned to leave the property to her. He occasionally talked to her about the fact that the property would be hers someday and he encouraged her to sell it if she needed the cash. He didn't want her feeling obligated to hold onto it in his memory.

When Jonathan passed away, Martha inherited the property, which had a fair market value of $100,000. Two years later, a developer took interest in the property at a time when Martha was planning to start her own business. Remembering her uncle's talks over the years, she promptly sold the property for $200,000.

Luckily, Martha's basis in the property was not the original $10,000 but $100,000 (the FMV at the time of her uncle's death). Martha is in the 15% capital gains bracket and gets a significant tax savings from the step-up in basis:

Original basis	$10,000
FMV at Jonathan's death	$100,000
Martha's new basis	$100,000
Martha's sale price	$200,000
Martha's gain subject to tax	$100,000
Capital gains tax	$15,000
Capital gains tax savings	$13,500

(Untaxed gain due to step-up: $90,000 x 15% = $13,500)

Martha only owes capital gains tax on the $100,000 appreciation during the time she owned the property (not the $190,000 appreciation since her uncle bought the property). In other words, as shown above, she does pay $15,000 in capital gains tax, but she avoids paying an extra $13,500 thanks to the step-up in basis.

The proposed AFP would eliminate the step-up in basis for capital asset transactions in excess of $1 million. According to the administration, this will limit the impact of the loss of the step-up to only the wealthiest of estates. However, critics contend that the middle-class could be affected the most—if a relative passes away and leaves a piece of appreciated real estate, it could create a large tax liability if heirs need to sell the property. This is particularly worrisome as real estate valuations continue to skyrocket—the average home value in 2000 was $126,000, whereas in 2021 the average sale value was between $340,000 and $408,000 (depending on the source). With these numbers, it is equally plausible and painful for middle-class inheritors to contemplate an increase in value of over $1 million for a home (especially one bought before 2000 or in premium real estate areas such as California).

DONOR IMPACT

If this change becomes law, it could certainly end up impacting more than just the very wealthy. Some affected taxpayers may decide that the best solution for their situation is to donate the appreciated property and leave other

assets to children or other family members. This would result in a win for the charity and also for the donor, who could further a philanthropic legacy while minimizing tax liabilities.

Child Tax Credit

If signed into law as it stands, the AFP will expand the Child Tax Credit that was passed in the TCJA and make it permanently refundable. The White House notes that the proposed legislation "expands the Child Tax Credit from $2,000 per child to $3,000 per child for six-years old and above, and $3,600 per child for children under six. It also makes 17-year-olds eligible for the first time and makes the credit fully refundable on a permanent basis, so that low-income families—the families that need the credit the most—can benefit from the full tax credit."[8] The AFP would also make this a credit that is "delivered regularly," meaning that a family claiming this credit would receive regular payments during the year rather than waiting to claim the credit at tax time each year.

DONOR IMPACT

Those in the upper tax brackets are typically the focus for larger charitable donations, but those in the lower and middle-income tax brackets may still be consistent and faithful charitable givers. While these donors may not be able to make a large one-time gift, a lifetime of smaller weekly or monthly donations can still result in a significant overall gift. For some of the families who will receive this expanded tax credit, the decrease in their financial burden could result in an increase in regular donations.

The Accelerating Charitable Efforts Act

Donor-advised funds (DAFs) represent a significant repository of monies donated annually for charitable causes. Though DAF contributions generate an immediate tax deduction for the donor, funds may fail to reach charities for some time, since there is no requirement that specifies when DAF contributions must be allocated to a charitable institution. Funds in a DAF can remain unallocated and are frequently hosted by large financial institutions that offer various investment options to DAF account holders.

A pending Senate bill—the Accelerating Charitable Efforts (ACE) Act[9]—seeks to shorten the time between a donation to a DAF and use of the funds by a charitable organization. The ACE Act would require DAFs to disburse funds within a "reasonable" timeframe and establishes three specific types of DAFs:

- **Qualified DAF**. An agreement with a sponsoring organization where donor advisory privileges would expire 15 years after the contribution. Donors would be required to name a "preferred" organization to receive the donated funds.
- **Community Foundation DAF**. These DAFs would not be subject to payout minimums for accounts up to $1 million and would allow an immediate tax benefit. Accounts over $1 million would receive immediate tax benefits only if the DAF has a 5% annual payout or requires donations to be distributed within 15 years. For donations of non-publicly traded assets, no charitable deduction would be allowed until the contributed assets are sold.
- **Nonqualified DAF**. These DAFs would fall outside of the two previous categories and would not allow a charitable deduction until funds are distributed (or sold and distributed, in the case of donations other than cash), with such distributions required within 50 years of the contribution.

DAFs would face a 50% tax on the total amount (contributions plus appreciation) that has not been distributed within the specified time frame.

DONOR IMPACT

The ACE Act has not met with universal approval. Many in the charitable giving community believe that the new rules would only serve to suppress future giving, while others believe it is a positive step that will unlock charitable donations currently sitting in DAFs and get the money out to the charities faster. Contributions made prior to the

bill's enactment will be grandfathered in under the current rules, meaning some donors who prefer to leave money in a DAF for longer periods may wish to make their contributions sooner rather than later.

Home Run or Big Miss?

Perhaps the opposite of Babe Ruth's "called shot" is Mighty Casey's misplaced certainty in Ernest Lawrence Thayer's poem "Casey at the Bat." Up to bat in the final inning and fully intending to bring his team to victory, Casey was not as fortunate as the Babe:

> *Oh, somewhere in this favored land the sun is shining bright,*
>
> *The band is playing somewhere, and somewhere hearts are light;*
>
> *And somewhere men are laughing, and somewhere children shout,*
>
> *But there is no joy in Mudville—mighty Casey has struck out.*

President Biden has stepped up to the plate and is taking a proverbial swing at changing our nation's tax policy. Though the contents and specifics of the American Families Plan will certainly change over the course of the debate on its ratification, the Democrat-controlled House and the presence of Vice President Harris as a tiebreaker in the Senate makes it possible that, with enough party-line maneuvering, it could pass almost as proposed. With rising inflation, a burgeoning stock market, and exploding home values, the increased tax on capital gains alone could have a farther-reaching effect than the stated desire to impact only the wealthy.

At this point, there is no clear answer as to whether the American Families Plan will be a home run or a big miss, and the same can be said for the Accelerating Charitable Efforts Act. What is certain is that knowledge, planning, and preparation are the keys to navigating any tax policy that comes out of Washington.

ENDNOTES

1 https://baseballhall.org/discover-more/stories/baseball-history/called-shot
2 https://www.whitehouse.gov/briefing-room/statements-releases/2021/04/28/fact-sheet-the-american-families-plan/
3 IRC §1411.
4 IRC §1001(a).
5 IRC §1(h).
6 IRC §1410(a)(1).
7 In IRC §1410, the elections mentioned in 1410(a)(2) and 1410(a)(3) refer to alternate valuation dates for the estate under 2032 and 2032a. The exclusion under 1410(a)(4) refers to an estate with land subject to a conservation easement.
8 https://www.whitehouse.gov/briefing-room/statements-releases/2021/04/28/fact-sheet-the-american-families-plan/
9 https://www.congress.gov/bill/117th-congress/senate-bill/1981/text

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