BLB&B Advisors, LLC
FINANCIAL GUIDANCE SINCE 1964

BLBB Business Advisory Summer Update Transcript

Recording Transcription (Recorded 06.02.2021)

Disclosure: *This content is informational only and was recorded on June 2, 2021. BLBB does not provide tax advice nor practice law. This content does not consider your specific financial circumstances and objectives and may not be appropriate for you. Please consult with your licensed tax or legal professionals who can advise you based on your particular facts and circumstances.*

1. We're going to start off by talking about positioning your business for rising taxes, including business transitions in light of decreased estate tax exemption and rising estate tax rates. So, Doug, what tax rates will be coming?

There's a lot of uncertainty, ultimately, what will reside. There definitely seems to be a change on the corporate tax side and the individual tax side, which obviously affects people that have pass-through entities like LLCs, partnerships, and subchapter S's. And there are some other additional taxes to be mindful of. With respect to corporate taxes, the current proposal is to take corporate taxes from 21% up to 28%. Where that settles out is going to be a function of what gets through Congress, the House of Representatives, the Senate, and the President. Friday, May 28, the President did propose his fiscal year end-2022 budget which gave additional clarification to some of the proposed taxes. The two laws proposed to implement these taxes would be a $2.3 trillion in infrastructure or a more traditional infrastructure plan called the American Jobs Plan and then a second, $1.8 trillion infrastructure plan which is more focused on human infrastructure called the American Families Plan. The tax changes would be incorporated through these plans.

The proposed corporate tax rate is going from 21% to 28% and that's proposed to be effective January 1, 2022. Where that ends up, we need to see, could be 25%, could be 28%, does seem fairly certain that it's going to be higher than today's 21%. There's also a proposed minimum book tax income for large corporations having taxable book income in excess of $2 billion. That would be a 15% tax rate. The large corporations ($2 billion in book net income) would be paying the higher of the 15% minimum rate or the higher 28%, or final tax rate.

2. What potential changes are coming for individuals that have pass-through entities?

There're some real significant proposed changes in this area. As a reminder, pass-through entities are partnerships, limited liability companies, and subchapter S's. The owners of those businesses really need to be mindful of the changes that are being proposed as they are quite significant.

For individuals, the top tax rate today is 37% and the proposal is to take that to 39.6% effective January 1, 2022. One of the more significant proposed changes is to increase the long-term capital gains tax rate for incomes over a million dollars to the top ordinary rate at the time. That would mean today that the top long-term capital gain tax rate of 20% would go to 37%. And if the new higher tax rates passed, it would take 20% up to 39.6%, which would be effective January 1, 2022, which is basically a doubling of the long-term capital gains tax rates. So, it would be pretty significant.

The proposal to take the 20% tax rate up to 37% (today's long-term top ordinary income rate) is proposed to be effective April 28 of '21. This is basically, a proposed retroactive change effective April 28th, '21. The rate to go to 39.6% for long-term capital gains for incomes over a million dollars would be January 1, 2022. In addition, individuals of partnerships, limited liability companies, and subchapter S companies, corporations need to be mindful that there's also proposed changes on the net investment income and the self-employment tax. So net investment income is 3.8%. Self-employment tax is 12.4%. In essence, the proposal on the table, which was released Friday, May 28th through the President Biden Administration budget for Fiscal Year 2022, is to tax all pass-through income at either a net investment income tax rate or self-employment tax rate on top of the regular ordinary rates. That's another thing to be mindful of. Candidate Biden had proposed eliminating the qualified business income or the Section 199-A pass-through taxes. And that basically, as you may recall, is essentially not taxing 20% of the income for qualified businesses taxable income. In the proposal that was released Friday, May 28, that was not proposed. So as of today, there is no proposal to remove that 20% reduction in what's taxable.

3. When would these changes take effect?

Most of these changes would take effect January 1, 2022. The real surprise is, as proposed, the long-term capital gain tax rate at the highest change to the highest ordinary income tax rate is proposed to be effective retroactive April 28, 2021. Again, that may change, but that would basically implement, for incomes over a million dollars, the long-term capital gains tax rates for those incomes over that would be taxed at, today 37%, effective January 1, 2022, 39.6%.

4. What is going on with gift and estate state taxes?

There are some very, very significant proposed changes on the gift and estate taxes. The first change I'd like to talk about is what was released in the President Biden Administration budget last Friday May 28, and this is consistent with what he campaigned on as his platform. This is to reduce the step-up in basis which is basically adding a tax on the unrealized capital gains on estates. If you have an estate that, let's say worth $10 million in assets and it has a cost basis of a million dollars, the proposal is to tax the appreciation, which in this case would be $9 million at the estate level - and this is before we get into the estate tax. There is a proposed $1 million exemption so that the first million dollars of unrealized capital gains would not be taxed. In this example, with a $10 million fair market value estate, which has a cost basis of a million dollars, you would get a million-dollar exclusion. And that difference of $8 million would be taxable income which would be taxed on that estate's final year-end tax return.

The challenge is that that's going to significantly drive up that year's tax return for the estate. And so essentially, you're looking at $8 million in taxable income, which is well north of a million dollars, assuming no other income. And there could be ordinary income, interest income as well.

Let's take as an example, that $8 million. And in the long-term, if the income on that estate tax is over a million dollars, that's going to trigger the capital gains to be taxed at the highest ordinary income rate which effective January 1, 2022, is going to be 39.6%. For simple math, let's just round that to 40%. In simple terms, $8 million is going to be taxed at 40% or you're going to have a tax rate of $3.2 million, which is going to be a reduction in what the estate would be able to distribute. That's before an estate tax.

Today's estate tax has an exemption of $11.7 million for an individual. If an individual passes away today and their estate value is less than $11.7 million, they're not taxed at a federal level. State taxes have lower levels. If you're in a state that taxes, you could well be in an estate tax situation - but at the federal level, you wouldn't be taxed.

Candidate Biden's proposal was to lower the exemption amount. And that could be lowered to as low as $3.5 million. If you have an estate tax, and before we said the fair market value was $10 million with the current tax at $3.2 million in the previous example, that would basically leave $6.8 million to be distributed.

If the new exemption, and we haven't seen yet what that new exemption rate would be, would be 3.5. You basically have 6.8 less than 3.5 or $3.3 million of the estate, which would be taxed at 40%. And the rate could be higher. Candidate Biden indicated that they might be looking at higher estate tax rates. You'd basically have the tax that the estate would be paying before, and in our example, I think it was 3.2 million, and then you'd have 40% of the $3.5 million taxes. So that would be 1.3 million

You have another, something like $1.3/$1.4 million worth of estate tax that you would be paying. You lump that up, you're basically looking at over $4 million in estate tax that, might happen effective January 1, 2022, that you wouldn't have if somebody died today. There're some really significant impacts to proposed estate taxes. There are certain exemptions that might exist and that's basically for family businesses and farms if the heirs continue to run the business and continue to own the business, but more of those details need to be worked out.

5. How can I plan for these changes to reduce the impact to annual after-tax profitability?

With tax rates basically going up, you're in an unusual situation where you probably want to accelerate income in 2021, because there's a lower tax rate, and you want to defer expenses into '22. Now, obviously you have to be compliant with the tax code, but there is flexibility, especially for cash basis taxpayers on when they're recognized, when they're recognizing expenses, and some opportunities for recognition of revenue. Note that with the long-term capital gains tax rates proposed as of Friday, May 28, and the President Biden Administration's budget for Fiscal Year-end 2022 being April 28 of 2021, you want to be mindful of not triggering it, or being very careful in triggering, capital gains because those tax rates could be an ordinary income if total taxable income for the individual exceeds a million dollars. You really need to look at that carefully for the long-term capital gains taxes. But for ordinary income, which is today through Fiscal Year-end '21, is *proposed* as currently 37%. And next year, 2022, is proposed to go up to 39.6%, the highest marginal rate. Generally, you're going to want to consider accelerating revenues and deferring expenses.

6. How might the changes impact my selling the business or passing it along to the next generation of employees?

These proposed tax changes are very significant to entrepreneurs with businesses looking to pass that on or sell that for retirement. The principal challenge is going to be twofold. It's going to be the higher, long-term capital gains tax rates for incomes over a million dollars. It's particularly problematic for entrepreneurs that have started out and typically have taken not much income at all, leveraged, built businesses, and looking to fund a retirement. And they've had, as of today, the ability to get taxed at long-term capital gains tax rates when they sell their business which is today, 20%. The proposed changes of taking the long-term capital gain tax rate for incomes over a million dollars up to 39.6%, is very problematic for these owners/entrepreneurs. They definitely want to think about an exit plan. We need to see what's finally passed and gets through Congress and what's signed by the President, to become the new tax law. But certainly, you're going to want to give some thought to perhaps level-loading and selling pieces over time to try to minimize long-term capital gains tax rates. That could be especially applicable if you're transitioning a family business to the next generation, or if you're planning to transition the business to the next generation of direct reports, but it's definitely going to be an issue. And the estate tax changes are going to be quite significant as well, because of the gifting in estate taxes. Basically, there's a significant reduction to the today's $11.7 million per person gift and estate tax exemption which Candidate Biden had proposed taking down to as low as $3.5 million with a gift and estate tax of 40%, which could be increased as well. The facts and circumstances are quite significant and make a difference. And that's something we would enjoy and appreciate talking to entrepreneurs about. There are some very significant impacts to these proposed tax changes, which should be revisited on businesses that are valued in excess of $3.5 million.

7. Now we're going to talk about mitigating business financing risk in a rising interest rate environment. Why should I be thinking about this now?

Now is a particularly good time to be looking at your financing structure and consider terming out, basically getting medium and long-term debt financing in place. Today we have historically low nominal and real interest rates. There's also been an unbelievable amount, and historic by any measure, of stimulation to the economy (fiscal stimulation) through budget transfers and also a very stimulative federal reserve through the monetary policy.

The effect is to basically keep interest rates at extremely low levels right now. And again, below the expected rate of inflation, and inflation, as most of you know, is a component to interest. Basically, if the market believes that inflation will be occurring in years, two, three, four, five, etc. they're going to demand a higher interest rate. And so today it's rather unusual, but the real rate of return - which is the interest rate less the expected inflation rate for risk-free assets - (think of U.S. Treasuries) is negative. If you're buying a treasury inflation protected security, a bond, there's actually a negative yield rate. Also, the federal reserve through this monetary stimulus is basically loaning money out today to banks at six basis points or six one-hundredths of 1% per year. In essence, and this is what you're not getting, you're not earning any income on your savings or checking accounts at the local bank.

The ten-year treasury is at 1.61% and the five-year treasury is at 81 basis points or 0.81%. And that means that the banks have incredibly low cost of money. So now would be a good time to think about locking up some medium and long-term financing to take advantage of these low rates, because if inflation increases as a result of all of the fiscal stimulus, that's going to drive inflation higher which is going to drive interest rates higher.

And at some point, the federal reserve is going to stop there, or tail back their monetary stimulus, which by the way, if they're buying $120 billion a month net of investment assets. And that's basically keeping down the price of ten-year treasuries and also mortgages. Another component of interest is the perceived risk. And today, banks are generally perceiving that the market economy, and hence businesses that are interested in borrowing money, are probably in a lower than normal risk profile because there's so much money that's being flooded into consumers' hands.

And consumers are going to spend those on products and services which are going to try to drive business revenues. In addition, businesses have taken a very hard look at their expenses as a result of COVID-19 and having to survive. The businesses that are alive and sustaining today have already gone through that stressor. And they've also taken a lot of expenses out of their income statement, so that with higher revenues and reduced expenses, that's basically going to be driving projected higher net incomes, which basically is cash flow that we'll be able to support the repayment of bank borrowings.

So again, you have low interest rates today and that's because today there's low inflation, although there's risk that that inflation will increase and you have relatively high confidence in banks on a generic loan because businesses have been through this extremely stressful COVID-19 situation. And also, businesses are seeing that consumers are flushed with capital and cash, that they don't have this pent-up demand, and are willing to spend. Those factors coming together really make it a particularly good time to be looking at terming out or financing medium and long term some of the business.

8. So then let's talk about exploiting opportunities arising from supply chain management actions your major customers are taking. What business opportunities do you think might exist here?

There are some significant opportunities with COVID-19, having gone through that, and also the fundamental U.S./China rivalry which exists today, and candidly will probably continue for decades in the future, that's driving large companies to really reconsider where they're sourcing their key components and production facilities. This is creating a significant opportunity for small businesses to basically support those larger businesses. Think of the Fortune 500 company, think of a pharmaceutical company in our area; obviously, the admitted Atlantic region is very strong for pharmaceuticals. They're rethinking where their critical ingredients and drugs are being assembled and manufactured. And so if they're basically going to be building new factories and plants and requiring new equipment, that's a significant opportunity for U.S.-based smaller and mid-sized businesses to support those large companies with the introduction or re-introduction, or reassuring, of major factories and plants in the U.S. by helping them construct their facilities, providing services to those factories or warehouses once they're up and running, and maintaining the equipment and supporting the personnel that are keeping those running.

9. Do you have any other quick ideas we should consider?

Yes, there's a couple of other opportunities entrepreneurs should be considering with their businesses. Don't forget the federal employee retention tax credit, sometimes abbreviated as ERC, that's basically a tax credit on eligible payroll and its dollars. And as a reminder, that's eligible payroll dollars that have not been applied to the paycheck protection program forgiveness. That can be 50% of payroll dollars and a nice help to some of the entrepreneurs to get through a difficult time. For New Jersey-based tax payers, if they have entities that are sited in New Jersey, and they have a personal presence in New Jersey, they should be encouraging those businesses to be thinking about taking advantage of the business alternative income tax or BAIT tax credit. This is a mechanism or strategy that New Jersey has adopted to bypass the $10,000 federal, state, and local tax deduction cap of $10,000.

Think LLC partnership, subchapter S, that entity basically paying a portion of the New Jersey taxes directly to the State of New Jersey, putting that on the entity's tax return which gets onto the investor or owners K-1. The owner is able to take a deduction for those New Jersey state taxes through their K-1 to avoid the $10,000 limitation in their Schedule A itemized deduction. There are some procedural rules and planning, but this is an opportunity to take advantage of it. Again, another opportunity is to look at the federal research and development tax credit – as a reminder, we've written about this before and there's some information on our website on that, but be mindful. That's not just R and D for the product or the invention, but it also applies for innovative ideas on process.

The efficiency of processing manufacturing or delivering services can also be qualified expenses on which the business might be able to take an R and D tax credit which could flow through to its owners. Another opportunity is to be mindful of if businesses are funding medical benefits for their employees. There's a Blue Cross/Blue Shield settlement that has just recently arrived. It basically was a class action lawsuit alleging uncompetitive behavior. And as a result of that, Blue Cross/Blue Shield needs to put $2.7 billion of money into the overall settlement. And a portion of that, a significant portion of that is going to be distributed to impacted individuals, companies that had individual and group insurance policies through Blue Cross/Blue Shield from February of 2008 through October of 2020.

These businesses are going to want to look at the website www.bcbssettlement.com. Basically, by filing a notice, which is a summary of what your premiums were for that 12-year period, that business might be able to get a pro-rata settlement of a portion of the $2.7 billion. Something to be mindful of.

The last item is not really an opportunity, but I do want to highlight the importance of cybersecurity. This is the importance of defense. We're reading with increasing frequency the damages and the expense of cyber security breaches. All entrepreneurs, and everybody as an employee, really needs to be mindful of the cybersecurity concerns, because large criminal organizations and large state actors, directly or indirectly, are driving criminal organizations. Especially those situated in the U.S., are being subjected to greater and greater probabilities of being impacted by this. We really need to be mindful.