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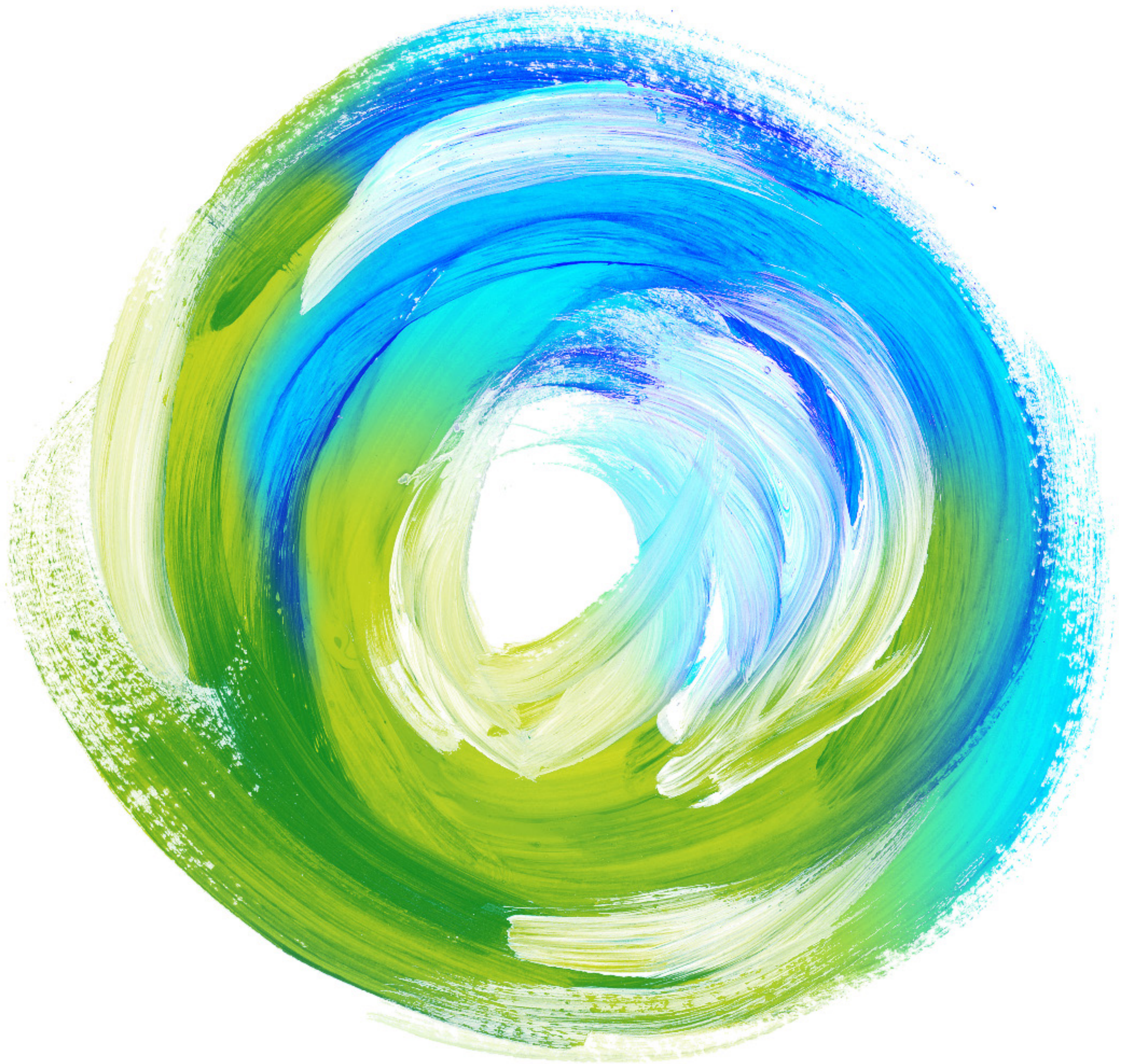

Navigating an uncertain tax rate environment

Introduction

President Biden recently called for increasing the top individual income tax rate and the capital gains tax rate, repealing like-kind exchanges for gains of more than $500,000, eliminating stepped-up basis for certain inherited assets, and various other tax hikes focused on upper-income taxpayers to help offset the cost of his proposed $1.8 trillion "human infrastructure" initiative known as the **American Families Plan**. The American Families Plan is further described in the General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals, otherwise known as the "Green Book," released by the Department of the Treasury on May 28, 2021.

Even though significant tax code changes appear to be a real possibility, it's difficult to know exactly what may be enacted into law. Political and economic considerations could affect some of President Biden's proposals, which may be modified or eliminated, as his plan moves through the legislative process. With this in mind, it is important to be mindful when it comes to questions of tax planning. Simply put, there may not be an easy, quick, or uniform answer. More importantly, facts and circumstances matter.

Before acting in response to a potential tax change, taxpayers should model a proposed transaction over several years, considering alternative scenarios, based on the best information available at the time.

When evaluating the impact of potential tax rate changes from the perspective of a specific event, in a vacuum, a taxpayer's view may be that their tax liability will increase by the mere fact of an increase in tax rates. A critical aspect of understanding one's tax posture is to model the tax consequences using various fact patterns and scenarios over multiple years. Additionally, modeling may provide options to consider that can aid in making an informed decision after considering all facets of the issue (e.g., business, personal, and tax changes) and may help to avoid rash decisions. It is also important to remember that, at this time, there has been no legislative action on aspects of the American Families Plan.

This publication identifies some, but not all, issues that should be considered when contemplating the sale of a closely held operating business in an uncertain tax rate environment and discusses certain tax provisions included in the American Families Plan that may become applicable to planning for the sale of the business, should the proposed tax changes become law. This discussion is framed in the context of a fictional taxpayer, Tom. While this example focuses on a fictional sale of a business, we encourage you to reflect on how components of this story could be relevant to you and the modeling you may consider for your personal situation.

For a high-level summary of the proposed tax increases included in the American Families Plan, see **Deloitte Tax News & Views.**

Setting the stage

Tom owns a successful chain of organic grocery stores, which he started in the 1970s. The grocery stores are currently held in a partnership. Tom owns a 90% interest. Each of his two children own a 2.5% interest. The remaining 5% interest is held in a trust for the benefit of his grandchildren. Tom materially participates for purposes of the passive activity rules in the trade or business of the partnership, while the other three partners do not.

Recently, Tom has pondered retirement and is weighing his options with respect to the grocery store business. Although he would love to pass the business to his two children, neither is interested in following in his footsteps. As such, Tom has concluded that the grocery store business should be sold within a year. He has received significant interest from various third parties[1] and is anticipating a significant gain from the sale.

One potential buyer has offered to purchase the assets of the partnership in either 2021 or 2022, with the possibility of an installment sale over three years. Tom is concerned that he will pay significantly more taxes if the transaction closes in 2022, given his belief that long-term capital gain rates may be increased and be as high as the ordinary income tax rates for certain taxpayers. Lastly, he is interested in understanding whether any of the long-term capital gain from the sale will be recharacterized as ordinary income.

Understanding what's important

Tom has decided to move forward with the sale of his business. Because of his personal view that long-term capital gains rates are expected to increase in taxable years

beginning after 2021, he is anxious to close the sale as soon as possible. When contemplating a transaction like this, decisions should not be rushed or made without proper planning. Tom made the prudent decision to work closely with his trusted advisers to outline his financial and personal goals and to think through the best path to achieve those goals while efficiently managing his tax liability. What is important to a particular taxpayer will vary. Because of the diversity in priorities, this step is an important one in the modeling process, as it provides measurable objectives and a well-defined end goal.

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1. Note that there would be different and additional considerations if Tom were to sell the partnership to a related party. Related party considerations are beyond the scope of this publication.

Structuring the sale: General considerations

One of the first steps is for Tom to understand the various forms in which the sale could be effected to aid in structuring the sale in a tax-efficient manner while still meeting his nontax goals. Because of the complexity of the situation, including the types of assets owned by the partnership, and considering the implications of sales negotiations with the buyer, Tom and his adviser model various situations that are possible results of the sale.

Common forms of structuring the sale of a closely held partnership are selling the assets of the partnership or selling the partners' interests in the partnership.[2] Assuming the partnership immediately liquidates following the sale of its assets, the total net gain to be reported is the same. However, there can be differences in the character of the gain that is reported.

If the partnership sells assets, items of gain or loss will be passed through to the partners on their respective Schedule K-1, which are then reported by each partner on their personal income tax return. In an asset sale, gain or loss is computed based on the purchase proceeds allocated to each asset being sold. The type of asset sold dictates the character of the gain. Generally speaking:

- Assets constituting ordinary income property include, but are not limited to, inventory and depreciable property held for less than one year.
- Net gain[3] from real property and depreciable assets used in the taxpayer's trade or business and held more than one year (section 1231 property) are treated as capital gains (generally taxed at the preferential capital gains rates). However, exceptions to this general rule apply:
  - Gain from the sale of certain tangible personal property (referred to as section 1245 property) is recharacterized as ordinary income to the extent depreciation recapture applies.
  - Gain from the sale of certain depreciable real property is also recharacterized as ordinary income to the extent the section 1250 recapture rules apply. Depreciable real property not subject to the section 1250 recapture rules is taxed at a maximum rate of 25%.

If Tom were to sell his partnership interest, all or a portion of the gain from the sale of a partnership interest may be recharacterized from capital gain to ordinary income. Specifically, the sale of inventory, unrealized receivables, and the dispositions of previously depreciated assets may generate ordinary income. The 25% rate on gain from certain real property would apply. However, none of the gain would be treated as section 1231 gain.

Lastly, depending on the specific facts, a partner may be subject to self-employment tax or net investment income tax (NII) on all or some portion of their distributive share of partnership income or loss, as well as on the gain from the sale of assets or a partnership interest. Note that both taxes cannot apply to the same income by the taxpayer in a given year, and there are situations where neither tax may apply.

Deferral transactions

Important considerations when tax planning for any significant disposition event are certain nonrecognition and deferral provisions. Generally, these types of provisions allow a taxpayer to forgo recognition of gain in the year of the transaction and defer all or a portion of gain to a later taxable year. Tom heard from a friend about three common deferral provisions and was eager to learn more about how they worked and what steps needed to be followed to qualify for them. While not all-inclusive, these three specific opportunities are investing in Qualified Opportunity Zone Funds, reinvesting sale proceeds in a like-kind exchange, and use of the installment sale method.

> Generally, deferral transactions allow a taxpayer to forgo recognition of gain in the year of the transaction and defer a portion or all gain to a later taxable year.

Conventional wisdom might suggest that deferring income in an increasing rate environment is generally not tax-advantageous. Deferring the recognition of income may cause such income to be taxed at higher rates because gain recognized in future years is taxed at the rate effective in the year of recognition. This should be considered when the taxpayer models potential transactions.

2. This publication focuses on the sale of an operating business housed in a closely held partnership. Note that the analysis may be different if the operating business was held in a closely held C corporation or an S corporation, the discussion of which is beyond the scope of this publication.

3. Detailed provisions govern the netting rules for the sale or involuntary conversion of property used in a trade or business. A discussion of such rules is beyond the scope of this publication.

Qualified Opportunity Zone Fund: At the election of a taxpayer, recognition of all or a portion of capital gain from the sale or exchange of property to an unrelated party can be deferred to the extent proceeds generating the capital gain are reinvested in a Qualified Opportunity Zone Fund. The deferral period generally ends December 31, 2026. This topic may afford taxpayers additional considerations, which are beyond the scope of this publication.

Like-kind exchange: This provision generally allows a taxpayer to defer the recognition of gain from the sale or exchange of real property held for use in a trade or business or for investment if it is exchanged for other real property of a like kind, which is also held for use in a trade or business or for investment. Gain is deferred until the property is ultimately sold. However, given Tom's intention to retire and that other partners do not want to continue the business, this option is likely not realistic.

Installment sale: A taxpayer is required to use the installment sale method to the extent sales proceeds are received over several years. Installment sale treatment allows the seller to generally recognize gain as proceeds are received. This method of income recognition is generally viewed as taxpayer-friendly. Note that taxpayers have the option to elect out of the installment sale method and recognize all income in the year of sale.

Individual income tax considerations

After discussing the partnership sale and deferral transactions, Tom turned his attention to his own individual income tax liability. With the potential for both top ordinary and long-term capital gain rates to increase, Tom considered the following:

While tax issues are important, there are also significant nontax business issues that should be considered when contemplating and making decisions regarding these types of liquidity events.

- Accelerating the recognition of ordinary income;
- Deferring the recognition of business expenses into future years;
- Accelerating sales of long-term capital gain property already planned to be sold into this year and deferring sales of long-term capital loss property to future years;
- Matching the recognition of such losses with capital gains that cannot be accelerated; and
- Executing large planned charitable contributions in years with high tax rates to enhance the benefit.

The theory behind this discussion is that accelerating income may subject such income to lower tax rates in an increasing tax rate environment. Likewise, deferring deductions to later years may result in such deductions offsetting income possibly taxed at a higher rate than the current tax rates. Keep in mind that this list is not all-inclusive. At first glance, recognizing gain from a sale when tax rates are lower appears to be an easy decision, as does deferring deductions to higher tax rate years. However, as previously mentioned, nothing occurs in a vacuum, and the sale must

While the American Families Plan did not include proposals aimed at itemized deductions, charitable planning may become more difficult if proposals from the Biden campaign regarding capping the value of itemized deductions resurface.

be viewed with the whole picture in mind, considering any other investment income and deductions that the taxpayer may have. For example:

- Consideration should be given to the impact of the following on the qualified business income deduction under section 199A: the sale of the business; possible acceleration of income; possible deferral of deductions; and other items of income, gain, loss, and deductions. While the complexities of the section 199A deduction are beyond the scope of this publication, the deduction is generally equal to 20% of qualified business income, subject to limitations.
- The expiration of various favorable tax provisions should also be considered. The previous general statement includes deferring the recognition of business expenses. However, deferring the in-service date of eligible property subject to bonus depreciation after December 31, 2022, may not be ideal. This is because 100% bonus depreciation is currently scheduled to phase down after January 1, 2023.
- There are various other tax provisions not discussed here, which may affect the timing and/or amount of deductions allowed to a taxpayer. These other provisions, if applicable, should also be considered.

After exploring the issues discussed in this publication, Tom can begin to understand the complexity and importance of modeling and the significance of considering the interaction between the sale, other personal activities, and other pertinent provisions of the Internal Revenue Code. Keep in mind that the planning best suited for Tom may not be optimal for the other partners in the partnership (his two children and the trust for the benefit of his grandchildren). Those three taxpayers need to perform their own income tax planning because the same tax issue may result in different planning for different taxpayers due to their specific facts and circumstances, nontax financial issues, and personal goals.

For example, while Tom materially participates in the business of the partnership, the other three partners do not. As such, the other three partners may have previously disallowed passive losses that will free up as a result of the dissolution of the partnership. These partners will need to analyze whether the at-risk rules, excess business loss limitation rules, or other provisions affect the timing of the deductibility of the previously disallowed passive losses.

Looking ahead

Regardless of the state of tax policy changes on the horizon, thoughtful, long-term modeling may help mitigate risks. To that end, you should:

- Adopt a multiyear perspective in reviewing your tax situation, evaluating the tax implications of shifting income or deductions;
- View transactions with regard to both their economic and tax implications;
- Stay engaged with understanding the tax changes being debated by Congress and the administration so you can act quickly once Congress is prepared to enact tax increases; and
- Review your tax situation with a trusted adviser regularly.

While not discussed here, wealth transfer planning and/or charitable giving are generally important topics to discuss when a liquidity event occurs, as the taxpayer will have a significant amount of liquid assets to effectuate wealth transfer planning and charitable giving.

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