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Get Out Your Crystal Ball: The Challenges of Tax Planning in the Current Age of Uncertainty

In April, President Biden introduced the American Jobs Plan, a comprehensive proposal to increase investment in U.S. infrastructure. Concurrently, President Biden also announced his Made in America tax plan – the goal of which is to help fund the significant cost of this investment in U.S. infrastructure. While no legislation has been produced, the proposed tax plan includes significant changes to the U.S. federal income tax system, such as an increase in the U.S. corporate tax rate, an increase in the highest marginal U.S. federal individual income tax rate, and an increase in the capital gains tax rate for certain high-income individuals.

With tensions among and within the political parties, it is unclear whether President Biden's Made in America tax plan will be enacted in its proposed form, in some trimmed-down version, or at all. It is also unclear whether any changes will be effective retroactively or prospectively. For taxpayers engaging in transactions in the third and fourth quarters of 2021, this uncertainty can make tax planning more difficult than if there were certainty with tax rates.

Generally, it is well established that a taxpayer wants to defer income recognition and accelerate deductions. However, given some of the proposals in the Made in America tax plan, a taxpayer may consider tax planning that contradicts this fundamental principle.

To illustrate, assume a high-income taxpayer is selling stock of a corporation for cash in the third quarter of 2021 and that a portion of the taxpayer's cash proceeds will be held in escrow for one year after the closing date to protect the buyer against potential future claims. Traditionally, the taxpayer would be advised to take advantage of the installment sale method under Section 453 of the Code, recognizing the gain on cash proceeds received upon the sale in 2021 and recognizing the gain on cash proceeds held in escrow (or earned under an earnout) if and when they are ultimately paid to the taxpayer in 2022 (or later years).

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However, one of the proposals in the Made in America tax plan is to increase the capital gains tax rate that applies to high-income individual taxpayers to the highest marginal individual income tax rate. The taxpayer may need to consider electing out of installment sale treatment and recognizing the full amount of the cash proceeds, including the amount held in escrow (or earned under an earnout), in 2021.

Unfortunately, such a decision is not without inherent risk. If the Made in America tax plan is not enacted in its currently proposed form, capital gains tax rates for high-income individuals might not increase. Thus, the taxpayer's decision to elect out of installment sale treatment could result in a liquidity problem. The election could unnecessarily accelerate income recognition and tax on the full amount of the cash proceeds before the taxpayer actually receives the full amount of the cash. Fortunately, the taxpayer should have until filing a 2021 federal income tax return (including extensions) to choose whether to elect out of the installment sale method, unless the enacted legislation precludes such a wait-and-see approach.

As another illustration of how current uncertainty can impact both deal economics and tax considerations, suppose that shareholders are selling 100% of the stock of a corporation for cash on December 31, 2021. As part of the transaction, large change-of-control bonuses are going to be paid to certain employees of the corporation.

Traditionally, the selling shareholders would want the corporation to accrue these change-of-control payments on or before December 31, 2021 to take advantage of the corporate tax deduction associated with the change-of-control payments in the pre-closing tax period. However, if the corporate tax rate increases as proposed in the Made in America tax plan and is effective prospectively starting January 1, 2022, the selling shareholders may want to consider deferring accrual of the change-of-control payments until after the closing. Achieving this deferral may be complex and may require amending contracts, plans, or other agreements currently in place. But the benefits of letting the buyer take advantage of the increased tax deduction may be worth the effort if it gives the selling shareholders enhanced negotiation leverage in the transaction or enables them to share in the incremental corporate tax deduction via a purchase price increase.

Lastly, assume that instead of receiving all cash for their shares, the selling shareholders in the previous example receive part of their consideration in the form of rollover equity in the buyer. Traditionally, the selling shareholders would want to structure their rollover equity to take advantage of tax deferral under Section 351 or Section 721. However, given the proposed increase to the capital gains tax rate for high-income individuals in the Made in America tax plan, the selling shareholders may be in a position where it makes sense to avoid tax deferral and instead pay taxes on the rollover equity upon consummation of the transaction in 2021 at a lower capital gains tax rate. The same may hold true for tax-free reorganizations as well. In certain situations, for transactions occurring in 2021, it may make sense to avoid tax-free reorganizations and trigger corporate built-in gain now at a potentially lower corporate income tax rate.

These are just a few of the issues taxpayers are currently grappling with given the current state of uncertainty in the U.S. tax system. Until finalized tax provisions are enacted, taxpayers and their advisors will need to reexamine certain traditional tax planning strategies in light of their assessment of the likelihood of enactment, essentially taking a leap of faith before finalized tax provisions and their effective dates are known.

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