Planning Strategies

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Tax Changes Under the Biden Administration

President Biden campaigned on increasing taxes on the wealthiest Americans. Given the effects of the COVID-19 pandemic and a Democratic majority in both houses of Congress, we expect to see some tax increases. What will they be? When will they take effect? This article addresses both of these questions. In the first half of 2021, we expect to see tax legislation that is more or less easy to pass. Major reforms, such as a wealth tax, will take more time and may not pass at all. It is hard to predict what will happen, of course. But, there are some things we do know.

As a candidate for president, Joe Biden promised to increase taxes on the wealthy, and all Democratic candidates did so as well. Bernie Sanders even went so far as to put forth his own legislative proposal called the "For the 99.8 Percent Act."[1] At the time of writing this article, no firm legislative proposals have been introduced to increase taxes on individuals, estates or trusts. However, we expect they are coming. After the COVID relief plan is enacted this month, Congress will turn its attention to a major infrastructure spending package. So, what could we see in terms of tax changes this year and next under a Biden presidency?

Since there is a slim majority in both houses of Congress and a lack of any Republican support for more federal spending or higher taxes, we expect to see tax changes included in a reconciliation bill that will have a good chance of passing and can be implemented easily. For example, an increase in the marginal tax rate from 37% to 39.6% is very likely. If it passes by this summer as part of the infrastructure bill, this change could be done retroactively to January 1, 2021.[2] Other changes will be harder to pass, however. For example, we think the federal wealth tax proposed by Senator Elizabeth Warren has little chance of passing. Even Treasury Secretary Janet Yellen has said it is very difficult to implement.

[1] For the 99.8 Percent Act (Senate Bill S.309, Jan. 31, 2019).
[2] In 1993, a tax increase was passed retroactively to January 1. The U.S. Supreme Court has upheld retroactive tax increases in past decisions.

Again, since Democrats have such a slim majority in Congress, the legislative process that a tax bill would fall under is known as "reconciliation," which is a special procedure for budgetary bills that can be passed without the possibility of a Senate filibuster (Senate rules require 60 votes to advance legislation to a final vote). However, under a Senate rule that restricts what can be included in a reconciliation bill (known as the "Byrd rule"), the bill cannot include items that are extraneous to the budget or anything that would affect the Social Security program. The Byrd rule also prevents the bill from increasing budget deficits beyond 10 years, which often leads to sunset provisions as we saw in the Tax Cuts and Jobs Act of 2017 (TCJA).

Thus, certain campaign promises like a $15 minimum wage, which don't affect the federal budget, may not make it into a reconciliation bill. Further, tax deductions will be harder to enact than tax increases, which can be used as "revenue raisers" that lawmakers can use to support their individual legislative goals. Against that background, here is what we see looming on the horizon in terms of tax changes this year and next.

Capital Gains and Qualified Dividends

In addition to increasing ordinary income tax rates on persons making over $400,000 a year, Joe Biden also pledged to increase the top tax rate on capital gains and qualified dividends. Biden's proposal is to increase the capital gains rate from 20% to 28% (or even 39.6%) for taxpayers with over $1 million of gross income. Doing so, however, won't be easy. The policy debate over how to tax capital gains is an old one, and, although some increase is possible, we believe it less likely than a rate increase on ordinary income. Moreover, we think it is unlikely that a capital gains tax increase would be retroactive to January 1 of this year.[3]

Itemized Deductions

Starting in 2018, the State and Local Tax (SALT) deduction was limited to $10,000 per taxpayer (single or married). Politicians from states with high state income taxes (New York and California, e.g.) have pushed to have the SALT deduction reinstated. While it is very possible that the SALT deduction will return, there may be a catch. Biden has proposed limiting all itemized deductions to the 28% tax bracket. Thus, a person paying tax at a marginal rate of 37% would not get any incremental tax benefit over a person paying tax at the 28% marginal rate. Biden could also bring back the "Pease" limitation on itemized deductions which was eliminated in the TCJA.[4]

Retirement Accounts

President Biden's tax plan could eliminate deductions for contributions to IRAs, 401(k) and 403(b) plans and replace them with a new tax credit equal to a specified percentage of the amount contributed (which is currently expected to be 26%). The concept is to put higher wage workers on par with lower wage workers in terms of the tax benefit of making contributions to a retirement plan. In this case, individuals with a marginal income tax rate above 26% may decide to forego a traditional retirement account, and instead choose to go with a Roth account if IRA contribution rules allow it. While you would lose the 26% credit in the year of the contribution to the retirement account, you could receive tax-free distributions from the Roth account in the future.

[3] For higher-income taxpayers, a 3.8% tax on net investment income also applies to capital gains and dividends.

[4] The Pease limitation reduced itemized deductions by 3% of every dollar of taxable income above certain thresholds. The total reduction was capped at 80% of total itemized deductions.

Social Security Taxes

President Biden promised to make the wealthy pay more Social Security tax. Under current law, workers pay Social Security taxes on their wages up to $142,800. The tax is actually shared with the employer, where each party pays half the total tax (6.2% each). Biden's proposal is to create a "donut hole" of sorts by allowing the tax rate to be zero for incomes between $142,800 and $400,000, but to have it reinstated for wages over $400,000. This would be a major change and would not only affect high earning individuals but also their employers. In addition, self-employed individuals would have to pay the entire 12.4% tax (but may deduct half the self-employment tax). Such a tax increase would push the top tax rate for high earners in high-tax states upwards of 60%. However, for technical reasons, increasing the Social Security tax in a reconciliation bill is difficult. Therefore, we don't see this change as likely to pass early in the Biden presidency.

Taxes on Businesses

President Biden's tax plan would increase the federal corporate tax rate from 21% to 28%. The Biden plan might also eliminate the qualified business income (QBI) deduction for anyone with income over $400,000. Today, the QBI deduction allows eligible self-employed and small-business owners to deduct up to 20% of their qualified business income, including dividends from Real Estate Investment Trusts (REITs) and Publicly Traded Partnerships. The QBI rules were enacted in an effort to put small businesses (which are pass-throughs for tax purposes) and self-employed workers on the same level with corporations in terms of tax rates so that choice of business entity wouldn't matter. But the QBI rules are extremely complex and it's possible the entire thing will be cut, especially if the corporate tax rate is increased. The Biden tax plan also includes other tax increases on multi-national companies.

Like-Kind Exchanges and Carried Interest

We could see an elimination of the much-loved like kind exchange (also known as the 1031 exchange). This is a tax rule that mostly benefits real estate investors by allowing them to exchange investment real estate for another property without incurring an income tax on the exchange. It's especially valuable when the real estate has been fully depreciated because when depreciation is recaptured at the sale it is taxed at ordinary (rather than capital gains) rates. One other area that is surely up for consideration is the tax treatment of "carried interest." Carried interest is a form of in-kind compensation paid to investment managers of hedge funds, which many think should be treated as ordinary income instead of capital gains when the interest is cashed out.

"A reduction in the estate and gift exemption is widely anticipated."

Wealth Transfer Taxes

The TCJA doubled the federal estate and gift tax exemption from $5,000,000 to $10,000,000 plus an adjustment for inflation. In 2021, the current exemption is $11,700,000 per person.[5] For a married couple, the combined exemption is $23,400,000. However, the TCJA also built in a sunset provision that causes the exemption to revert to pre-2018 levels as of January 1, 2026, unless it is changed legislatively. A reduction in the

[5] The generation-skipping transfer tax exemption is also $11,700,000 and is similarly indexed for inflation. The GST tax rate is now a flat 40%.

exemption is widely anticipated by estate planners nationwide. The big question is whether it will be reduced to $5,000,000 or even $3,500,000 and when such a change would be effective. Most planners we have spoken to believe that a retroactive change in the exemption is unlikely. We agree with that consensus. Instead, a more likely outcome is a prospective change effective in 2022. There is also speculation that the new exemption amount could land somewhere between $5,000,000 and $11,700,000 but be made permanent (i.e., without a sunset).

Congress will also look at estate and gift tax rates. The tax rate actually affects the wealthiest families more so than does the exemption level. Currently, the top rate is 40%, which is close to the lowest it has been historically.[6] Biden has proposed increasing the estate and gift tax rate to 45% or more. Further, a rate increase could be done retroactively to January 1, 2021.

There also could be an effort to eliminate stepped-up basis at death. Another proposal is to require a deemed capital gain realization at death. Both of these changes would represent a major shift in tax policy and the federal government's approach to taxing wealth transfers. For that reason, we don't see them being included in a bill early in Biden's presidency. However, nothing is "off the table."

One area of reform that should gain some traction is the Grantor Retained Annuity Trust (GRAT).[7] Although sanctioned by statute, GRATs are perceived by some to provide an undue advantage and have been targeted for reform. Changes could limit the usefulness of GRATs by requiring a 10-year minimum term and a 25% remainder. Another possible change would be capping the ability to make annual exclusion gifts (currently $15,000 per year to an unlimited number of persons) to $50,000 per year. Such gifts allow grantors of trusts to finance large premium payments of life insurance policies owned by trusts that will escape estate and gift taxation. Both of these changes were highlighted in the Obama Treasury Department's wish list of legislative reforms in 2016. In addition, we could see tightening of rules on valuation discounting. Treasury Secretary Yellen could resurrect Obama era regulations that curtailed the ability to claim discounts for interests in family limited partnerships. These regulations, which were issued late in President Obama's second term, were quickly shelved per President Trump's mandate to cut federal regulations.

State Taxes

More than ever, people are paying attention to state taxes. Two major reasons for this have been the loss of the SALT deduction and the pandemic. The SALT deduction largely went away in 2018; what ensued was a slow trickle of people leaving high-tax states for lower-tax states like Florida and Texas. In 2020, it was the pandemic that caused massive disruption by forcing millions of people to perform their jobs remotely. This also had the effect of causing people to scatter from their usual abodes and places of work. The pandemic also made many people realize they can work (and attend school) from anywhere. However, one unforeseen issue of working from anywhere is how that affects your state income taxes. That question is now before the U.S. Supreme Court in a case called New Hampshire v. Massachusetts. Federal law might resolve the question but it is not yet clear when that will happen or how the new law would work. A few proposals were floated last year but nothing stuck.

[6] From 1997 to 2021, the top estate tax rate has ranged from 35% to 55%. In 2010, estates could elect either a 0% estate tax without a stepped-up basis or a 35% estate tax with a basis step up.

[7] For our advice on GRATs, see "The Great Thing about GRATS "(April 2020) www.1919ic.com.

> "Elimination of the Social Security cap, combined with the proposed New York rate increase, could mean that some New York City residents will face a combined top marginal rate of almost 70%."

States are also focused on keeping their tax base and, at the same time, keeping their wealthiest residents. The effects of high state taxation on migration will only be further magnified if states increase their taxes beyond a tolerable level or enact their own wealth tax. Washington State has already proposed a wealth tax on billionaires (some say it will apply only to four people). Will other states follow suit? Will these taxes dip deeper into the population of wealthy residents to gather more revenue? A big difference between state and federal taxes is that an individual can move to another state pretty easily and avoid the former state's taxes. So, if a state starts raising taxes too much, we could see a tipping point where wealthy people just move out. New York is one such vulnerable place. Florida and Texas (and other states committed to low taxes) could benefit. New York residents (and New York City residents in particular) could be hit especially hard as Governor Cuomo has proposed increasing the top New York State income tax rate to 10.86%, from 8.82%. Elimination of the Social Security cap (discussed above), combined with the proposed New York rate increase, could mean that some New York City residents will face a combined top marginal rate of almost 70%.

So, What Should I Do?

Much of the tax landscape is still uncertain. Last year, we advised clients who wished to take advantage of the high estate and gift tax exemption to make large gifts before the end of 2020. Some did so, some decided against it, and others waited. The exemption is still high and there is a good chance the window is still open. However, because of the way the rules work, it only makes sense to use the entire exemption ($11,700,000 or close to it). Using a smaller portion won't have much, if any, impact on your family's federal estate tax burden (although a smaller gift might work at the state level). We also advised clients to take advantage of low interest rates by making tax-efficient gifts (GRATs, intra-family loans). We highlighted the tax benefits of living in a no-tax state, such as Florida, as well as the pitfalls of keeping one foot in your old home state. In addition, with the suspension of RMDs in 2020 and anticipating higher income tax rates, we advised clients to consider a conversion to a Roth IRA to lock in 2020 tax rates.

We will continue to closely monitor tax changes as they develop. When considering your next planning move, we hope you will consult with your Portfolio Manager or Client Advisor at 1919 Investment Counsel, as well as your attorney or tax advisor. We would be happy to guide you through the process and this rapidly changing landscape.

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About 1919 Investment Counsel

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