Tax and Investment Consequences of a Biden Administration

The election of former Vice President Joe Biden along with very narrow Democratic majorities in both houses of Congress present investors with a number of concerns and perhaps some opportunities. We would like to try to separate rumor from reality as we offer our analysis of President Biden's prospective changes to tax and inheritance law.

While this was a divisive election with high emotions on both sides, it is important to realize that historically the party in the White House has had little effect on the performance of the stock market over the last century. External events like wars, economic slumps and, now, a pandemic have been more important to overall market performance. We suggest that long-term investors fight the urge to take too cautious an investment stance out of fear of prospective tax changes. Looking ahead, anticipated tax hikes will likely occur as COVID vaccines become widely disseminated and the country starts to open up after more than a year of "lock down," events that should be supportive to the economy and financial markets.

The Biden Tax Plan, which we explain in detail below, is almost certainly going to undergo major modifications before it becomes law. There are major and unpredictable differences between what candidates propose in the heat of the campaign and what eventually becomes law after Congress gets ahold of it. Importantly, the narrow majorities Democrats hold in both the House and Senate will probably mean that any tax law changes will have to pass muster with moderate Democrats from conservative states, and will disappoint the more progressive wing of the party. Therefore, we believe the changes will be in line with tax changes passed in both the Obama and Clinton administrations. It is worth noting that the stock market rose in both of the years those tax increases were passed. The Biden Plan, even if passed in its current form, would not affect all investors. Capital gains would rise only for those making over $1 million a year and income tax rates would rise only on marginal income over $400,000. This plan is designed to raise revenue primarily from those households in highest tax bracket. If you are in that group, the advice below may become even more important.

Biden Tax Proposals

Tax policy has been a major topic throughout Joe Biden's campaign. He has proposed tax increases for corporations and high-income households to help pay for his climate, infrastructure, R&D, health, and education plans. Some of the key elements of his proposals are summarized as follows:

- ***An increase in personal income tax rates for high earners*** – President-Elect Biden has proposed to return the top personal income tax rate to 39.6% for those earning income above $518,400 for single filers and $622,050 for joint filers. The rate is currently 37% for this income range. Further, the tax benefit of itemizing deductions would also be limited for those with incomes above $400,000. The 20% deduction for qualified business income would phase out above the same $400,000 threshold. Tax credits would be offered to help make childcare and housing more affordable for the middle class.

- ***Changes to itemized deductions*** – Biden's plan proposes restoring the Pease limitation, which reduces the value of itemized deductions by 3 percent of every dollar of taxable income above a certain threshold and capping all itemized deductions at 28 percent. Although not officially included in his published tax plan, he has suggested that he would revisit the $10,000 cap on state and local tax deductions, and potentially, eliminate it.

- ***A change in capital gains taxation*** - Notably, Biden also wants to end the preferential tax treatment of long-term capital gains and qualified dividends for households with incomes above $1 million. Capital gains and qualified dividends above that threshold would be taxed as ordinary income at 39.6% instead of today's 20% rate (plus 3.8% net investment income tax). For the vast majority of taxpayers, who have annual incomes below that threshold, the preferential rates would remain at current levels.

- ***Changes to the payroll tax to fund Social Security*** – Currently, Social Security is funded by a 12.4% payroll tax on wage and self-employment income, up to an annual cap that is adjusted for inflation ($137,700 in 2020). This tax is split between employers and employees. To address the program's growing funding deficit, Biden proposals would impose the 12.4% payroll tax on income earned above $400,000 as well. So, the payroll tax would apply to wages at or below $137,700 and above $400,000, creating a "donut hole" in the middle, where the tax does not apply.

- ***An increase in corporate tax rates*** - On the business side, he has proposed raising the corporate tax rate from 21% to 28%, reinstating a 15% minimum tax on profits exceeding $100 million, and increasing taxes on foreign profits.

The uncertainty of future tax law is causing a lot of anxiety for high earners. With that in mind, it is a great time to consider planning strategies to mitigate the impact of Biden's proposed tax increases. Once Congress passes any proposed legislation, we will have a much clearer picture of how Biden's proposals will impact high earners.

Biden's Impact on Estate Planning

Though President-Elect Biden has provided limited specific information on proposed changes to the federal estate and gift tax exemptions and taxation of assets following death, his goal in this area is clear: to provide more tax revenue for the government. As a result, there may be a limited amount of time for families to review and modify their estate plan to take advantage of the current favorable tax environment.

Key Takeaways of the Biden Tax Plan for Federal Estate and Gift Tax

- The federal estate and gift tax exemption amounts currently stand at $11.7 million per individual for 2021. However, the legislation that created these large exemption amounts is set to expire on December 31, 2025, with the exemption amounts slated to be cut in half at that time. It is very unlikely that this legislation is extended and the expiration date may very well be moved up.

- In addition, the Tax Policy Center has stated that Biden ultimately wants to reduce the federal estate and gift tax exemption amounts to $3.5 million and $1 million, respectively.

- Biden has also indicated that he may eliminate the step-up in basis that occurs when an asset is passed to heirs upon death. Under current law, inherited assets are assigned a basis equal to the fair market value at the time of death of the decedent. As a result, if such assets are sold at or near the time of death, there may be zero tax implications. If the step-up in basis is eliminated, all unrealized appreciation on a decedent's assets would be subject to tax on the subsequent disposition of such assets by the decedent's estate or beneficiaries.

Estate Planning Considerations and Strategies for High Earners

- Creation of Dynasty Trust. In general, dynasty trusts are long-term trusts designed to pass wealth from one generation to the next without incurring additional estate taxation. With the federal estate tax exemption amount at $11.7 million per person, many families had little concern about federal estate taxation at death. Should that drop to $3.5 million, a much larger segment of the population will be affected. Without proper dynasty trust planning, assets that could escape the 40% (and rising?) federal estate tax rate could be vulnerable.

- Use of Current Lifetime Gift Tax Exemption. As mentioned above, the current large gift tax exemption amount may be going away as political power shifts. However, the IRS has issued "anti-clawback" regulations, confirming that individuals will be able to use current gift tax exemption amounts and not be penalized if the exemption is reduced in the future. There are numerous estate planning options designed to take advantage of today's gift tax exemption amount, so please consult with your estate planning professional before it is too late.

When you develop a long-term investment plan with your MAI Advisor, it is designed to further your financial and life goals over the long-term and not be greatly impacted by short-term events. We encourage you to work closely with your Advisor and discuss the election's implications on your plan and how you can find opportunity moving ahead. Please don't hesitate to reach out to your MAI Advisor if you would like to discuss the concerns or potential opportunities discussed above.

Source: Tax Foundation, Fiscal Fact No. 730, October 2020; Details and Analysis of President-elect Joe Biden's Tax Proposals, October 2020 Update and Financial Planning, What is the Biden Tax Plan? October 21, 2020