Understanding Biden's Proposed Tax Plan

President Biden recently announced his $1.8 trillion plan (American Families Plan) for new benefit spending and increased taxes. Please keep in mind that this is the first iteration. We expect to see new items added and changes made as the proposal advances through Congress. Below is a summary to understand the proposed changes.

Capital Gains Tax

Right now, depending on your taxable income, the federal long-term capital gains tax rates are either 0%, 15% or 20% for most assets held for more than a year. High earners with significant investment income over certain thresholds pay an additional 3.8% surtax (net investment income tax) on top of the top capital gains tax rate (20% capital gains + 3.8% surtax = 23.8%). The Biden proposal would increase the top federal long-term capital gains tax rate to 39.6% and those high earners would still be subject to the 3.8% surtax creating an actual tax rate of 43.4%. This tax rate would apply to individuals and married couples (filing jointly) that make over $1 million a year (this includes dividends and capital gains) and is estimated to impact about 500,000 Americans (Source: Bloomberg).

	Current	Proposed
Top Federal Long-Term Capital Gains Tax Rate	20.00%	39.60%
Net Investment Income Tax	3.80%	3.80%
Total Highest Combined Rate	**23.80%**	**43.40%**

Note: The above reflects what has been proposed; the general expectation is that the capital gains tax rate will most likely be increased to around 28% (a rate that is roughly between the current rate and Biden's proposal).

What is Included in the $1 Million Income?

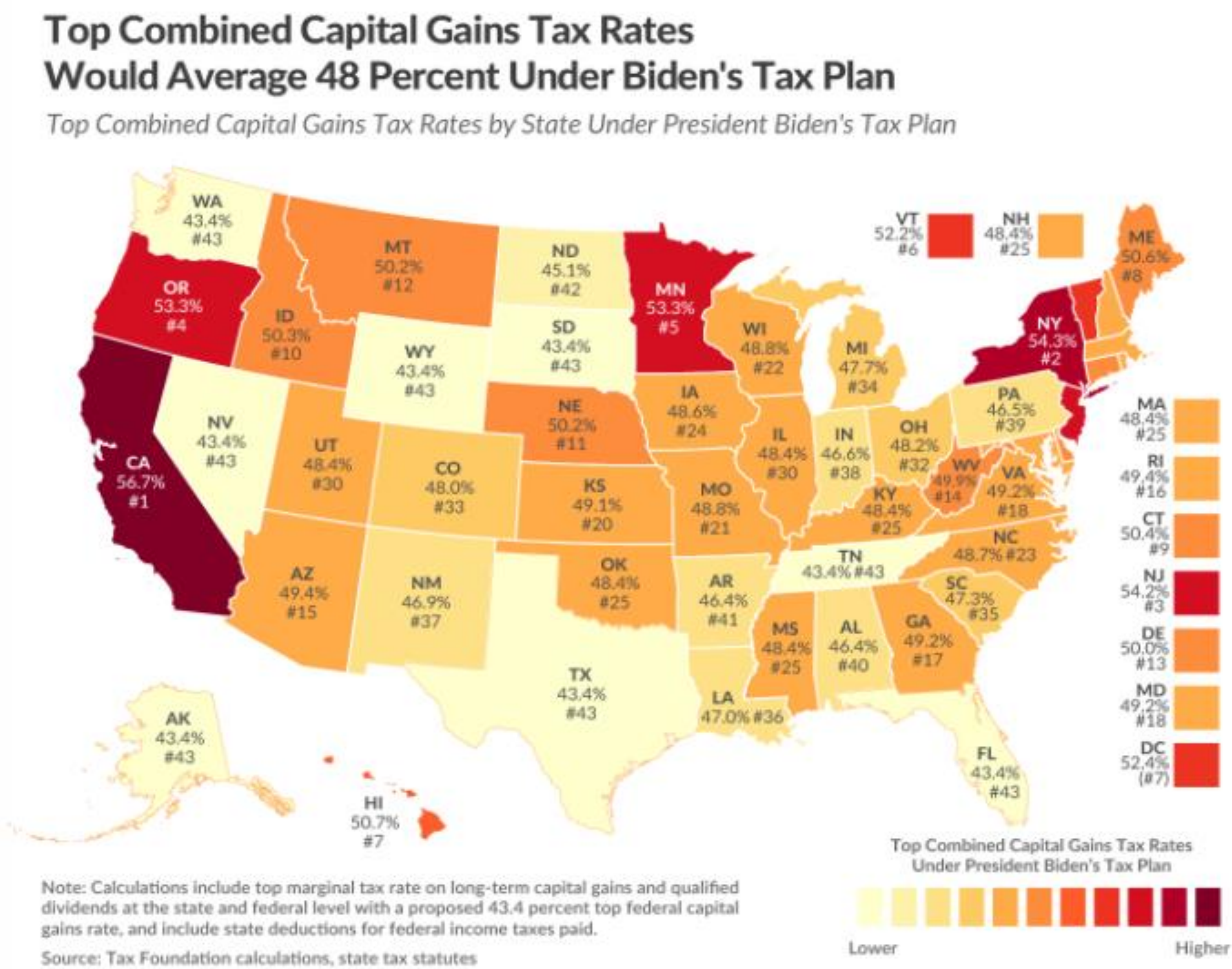
For now, the proposal appears to focus on those making more than $1 million annually. That means, most individuals would not be impacted by these changes. It is important to note, however, that the $1 million represents total annual income, which may include capital gains and qualified dividends (this could become an issue for anyone with a large liquidity event like selling real estate or a business).

What Assets are Impacted?

The new proposal would impact stocks and bonds. Individuals that sell a home or business with large capital gains would need to do additional planning as they would be impacted by these changes as well. There would not be capital gains taxes for family-owned businesses or farms if the heirs continue to run the business. Primary residences would still maintain the current exemption of $250,000 ($500,000 for a married couple) as well.

Factoring State Taxes

This increase would make the capital gains tax rate the highest it has been since 1954. When looking at this change combined with state taxes, individuals would become hugely impacted:



As you can see Californians in the top tax bracket and would be hit with a combined tax rate of 56.7% since California taxes capital gains at ordinary income tax rates.

Killing the Step Up In Basis

Another proposed change announced is the elimination of the current step-up in basis at death for gains of $1 million ($2 million for a married couple). Under current laws when someone passes the heirs receive a new cost basis on the inherited property, which is the value of the assets at the time of death (or, if elected, six months after the date of death). This new cost basis would eliminate capital gains that would have normally been taxed. The possibility of eliminating the step-up in basis is being discussed so that a strategy is not employed of just holding stocks until death to avoid paying capital gains taxes. Below is an example of what would happen if they remove the step-up in basis.

Example Under Current Law
Kim's father passes away and she inherits a taxable stock account worth $1.5 million with the original cost of the investments being $300,000. Under current rules, Kim will inherit the account and her cost basis becomes $1.5 million instead of her dad's $300,000. If she chose to sell the $1.5 million of stocks, she would not incur capital gains taxes.
Example Under Proposed Law
Kim's father passes away and she inherits a taxable stock account worth $1.5 million with the original cost of the investments being $300,000, meaning long-term capital gains of $1.2 million. Since the gain is over $1 million that means $200,000 ($1.2 million - $1 million exemption) is subject to capital gains tax that needs to be paid regardless if Kim keeps the stock or not. Assuming a proposed higher capital gains tax rate of 43.4% this would trigger a tax bill of $86,800 ($200,000 * 43.4%).

Note: The above reflects what has been proposed; the elimination of the step-up in basis is expected to be more difficult to pass without some revisions (possibly a phaseout).

Potential Planning Opportunities

Many different planning strategies would be impacted by these changes. In recent years we have seen a large disparity between the highest income tax rates and capital gain tax rates creating some unique planning strategies like Net Unrealized Appreciation (NUA).[1] If the capital gains rate is similar to income tax rates, then it is no longer a viable planning strategy.

Additional planning should be done if there is a large liquidity event like selling real estate or a business to defer or eliminate some capital gains taxes. Such as possibly using a Qualified Opportunity Zone Fund and other planning strategies.[2] Charitable gifting strategies (stock donations and donor-advised funds) are not expected to be impacted and may continue to be an attractive way to reduce capital gains taxes. We expect to see an increase in the use of charitable trusts as well in response to these proposed changes.

The real winner here is going to be the insurance industry. Life insurance death benefits are still tax-free and will become the best way to pay for these taxes or to pass money to heirs in the most efficient manner.

Potential Portfolio Management Considerations

Typically, you want to hold less tax-efficient assets (i.e., bonds) in tax-deferred accounts (i.e., retirement accounts, health savings accounts) to shelter the ordinary income generated. Under the proposal, for those earning more than $1 million in taxable income, we may want to consider flipping the script by (i) holding stocks that generate capital gains and qualified dividends in tax-deferred accounts, and (ii) holding bonds in taxable accounts, especially tax-free municipal bonds.

BFSG already builds portfolios in a tax-efficient manner, but others may want to consider holding more exchange-traded funds (ETFs) in taxable accounts which are usually more tax-efficient investment vehicles relative to mutual funds.[3] Furthermore, Real Estate Investment Trusts (REITs) would be favored to invest in and hold in taxable accounts due to a qualified business income deduction.[4] Finally, depending on the outcome of the step-up in basis proposal, many investors may want to invest for the long-term (buy and hold forever).

Finally, we will continue to tax-loss harvest portfolios (selling securities at a loss to offset securities sold at a gain) to minimize capital gains exposure.

What Do We Expect to Happen?

Whatever we do predict today is most likely to be wrong because we do not expect the proposals to go through without several revisions and changes. We expect to see more potential additions from Republicans and Democrats (i.e., possibly a reinstatement of the deduction for state and local taxes).

The proposal most likely will not be enacted until July or September, which is when we expect the Senate to debate and pass the reconciliation bill. The higher tax rates could become effective when the bill is enacted into law, given a retroactive effective date (May at the earliest), or delayed until January 1, 2022. The last time Congress legislated an increase in the tax rate (President Reagan and a Democratic House settled on an increase from 20% to 28%), the policy became law in October 1986, but the increase did not take effect until January 1987.

While tax increases are on the horizon, they are likely to be watered down by the time the final bill passes and take longer to be passed. We will continue to monitor the situation and keep you updated.

Sources:

1. Net Unrealized Appreciation (NUA) transactions occur when you convert employer stock in your 401k or retirement plan with your employer into a taxable account. When securities are sold, any NUA is taxed at the long-term capital gains rate. Any additional gain is taxed based on the holding period of the shares after they are distributed.
2. Investors can deploy realized capital gains from the sale of an appreciated asset into a Qualified Opportunity Zone Fund which may allow deferral, permanent reduction and elimination of capital gains taxes provided certain investment deadlines and holding timeframes are met.
3. Exchange-Traded Funds (ETFs) tend to have lower turnover (many ETFs are passive strategies), trade on a secondary market, and have a structural tax benefit of in-kind redemptions, therefore limiting capital gains.
4. The majority of Real Estate Investment Trust (REIT) dividends are taxed as ordinary income up to the maximum rate of 37% (returning to 39.6% in 2026), plus a separate 3.8% surtax on investment income. Taxpayers may also generally deduct 20% of the combined qualified business income amount which includes qualified REIT dividends through Dec. 31, 2025. Considering the 20% deduction, the highest effective tax rate on qualified REIT dividends is typically 29.6%.

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