DAC Insights: The Winds of Change… Summarizing Biden's Proposed Tax Plan

DIVIDEND ASSETS CAPITAL, LLC

INVESTMENT ADVISORS

DIVIDEND ASSETS CAPITAL – INVESTMENT STRATEGIES FOR RISING INCOME & GROWTH

In late May 2021, the Treasury released an overview of the 2022 revenue proposals for the American Jobs Plan and the American Families Plan, the so-called Biden Infrastructure and Tax plans, while providing further details around corporate and individual taxes. Below we've summarized the key components that may affect the financial situations of individuals and businesses.

INVESTMENT IMPLICATIONS:

Long-Term Capital Gains:

Under current legislation, the maximum long-term capital gains rate is 20%. For the current 2021 tax year, this will apply to single filers with incomes over $445,850 and married filers who file jointly with income over $501,600. The Net Investment Income of 3.8% also applies, bring the total maximum rate to 23.8%

The proposed legislation would increase the total maximum rate to 43.4% for tax filers with income over $1,000,000. The excess over this amount would be taxed at 39.6%, plus the Net Investment Income of 3.8%. The Net Investment Income tax applies to individuals and married tax filers with incomes more than $200,000 and $250,000, respectively.

Qualified Dividends:

Just as long-term capital gains would become subject to the Federal income tax rate for those filers with income over $1,000,000, so would qualified dividends. These too would be taxed at 39.6%, plus the 3.8% Net Investment Income, or 43.4%.

ESTATE PLANNING IMPLICATIONS:

Gifting:

The proposed legislation changes include the recognition of capital gains on 2 events:

- Gifting of appreciated assets.
- Beneficiaries receiving assets from an estate.

The proposed legislation would treat the above as if a taxable transaction has occurred, thus leaving the donor or the deceased owner with the tax liability.

There are exclusions and exclusion amounts written within the legislation:

- $1,000,000 gain exclusion per individual.
- Transfers to spouse, charity and personal residence will have exclusions or exclusion amounts.
- 15-year income tax payment plan will be provided for certain family-owned assets.

These measures, if passed, would become effective after December 31, 2021.

Limited Step-Up in Basis Upon Death:

Currently, most families or beneficiaries receive a step-up in basis to the current market value when inheriting appreciated assets when they acquire them. Thus, allowing these assets to be potentially sold without having to pay capital gains tax.

The proposed legislation would limit or cap the step-up of appreciated assets to $1 million per individual or $2 million per couple. This could also include the $250,000 individual and $500,000 married homestead exemption amounts for a primary residence.

Appreciation on assets greater than these amounts would be subject to capital gains upon transfer to the family or heirs. The appreciated assets subject to taxation, would have the basis adjusted to fair market value and then any value above the aforementioned exemptions would be taxed. For example:

> Mary purchased her home for $300,000, and at her passing it was appraised for $600,000 resulting in a $300,000 gain. She also has an investment portfolio valued at $3.5 million with a cost basis of $1 million resulting in a $2.5 million gain. Her total assets, at her passing, are valued $4.1 million with a total cost basis of $1.3 million and a total gain of $2.8 million.
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> Mary's estate would benefit from a $1.25 million step-up in value on the appreciated gain of $2.8 million. Her estate would use the $250,000 homestead exemption and the $1 million step-up in basis exemption. Under the proposed legislation, her estate would owe taxes on $1,550,000… the excess asset value gain of $50,000 above of the homestead exemption and the $1.5 million excess asset value gain above the step-up in basis exemption.

Note: for those philanthropically inclined, these gains would not be taxed if donated to charity. Also, there is a silver-lining for family-owned businesses and family-owned farms. If these qualified assets are passed down to family members who will continue to run the business or farm, they would be exempt from this proposal.

Estate Taxes:

The estate tax rate would remain at 40%, and the current exemption, $11.7 million per individual or $23.4 per married couple, would continue and be adjusted for inflation. However, the exemption amount is set to decrease to $5 million, adjusted for inflation, in 2026. There is current commentary around the proposed legislation that could move this adjustment date forward.

Trusts, partnerships and non-corporate entity assets will also be affected. Gains on appreciated assets, held within these entities, would be subject to realized capital gains tax, if no capital gains tax had been realized on the appreciated asset in the prior 90 years.

The look back date would begin on January 1, 1940. The first realized taxable gain date would be December 31, 2030 for all taxpayers. This proposed legislation appears to try and unlock the taxation of appreciated assets held within these entities.

INCOME TAX IMPLICATIONS:

Ordinary Income:

The highest tax rate would increase to 39.6% from 37%. This new tax rate would use the 2017 income tax bracket thresholds adjusted for inflation. This new higher tax rate may result in capturing lower income thresholds.

Remember, the current lower 37% tax rate is set to expire at the end of 2025. If legislation fails to pass, the top income tax rate will move to 39.6%, while leaving lower tax rates for qualified dividends in place.

These measures, if passed, would become effective after December 31, 2021.

Itemized Deductions:

Also being proposed is the restoration of the Pease limitation for those making more than $400,000 in income. This would limit deductions to no greater than the 28% tax bracket. If a tax filer is in the 39.6% tax bracket their allowable deductions would be no more than 28%, not 39.6%.

It appears SALT deductions may continue to be capped at $10,000 per year, and the mortgage interest expense deductions may be limited as well.

Corporate Tax Rate:

The current corporate tax rate is 21%. The proposed legislation would increase it to 28%. Commentators predict that negotiations might settle on 25%. The proposal also included a minimum corporate tax of 15% and allows for net operating losses and credits for corporations with income greater than $100 million.

Qualified Business Income Deduction:

Section 199A (qualified business income deduction) will be phased out for incomes greater than $400,000. Current legislation allows for a 20% qualified income deduction for those pass-through entities and self-employed individuals who are eligible. Careful planning, depending on business and income projections, will have to be considered to possibly mitigate future years in which incomes exceed $400,000 and disallow the Section 199A deduction.

Social Security and Medicare Tax Rates:

Social Security will be affected as well with the proposed legislation. Today, employees and self-employed individuals pay Social Security and Medicare taxes. The current wage limit is $142,800, and employees pay 6.2% while self-employed individuals pay 12.4%, which consists of both the employee rate of 6.2% plus the employer rate of 6.2%.

Under the proposed legislation Social Security tax rates would remain the same up to the current wage limit. However, the current rates would also be applied to wages above $400,000. So, Social Security taxes will increase for individuals making over $400,000 by 6.2% for an employee and 12.4% for self-employed taxpayers (it's complicated).

Additionally, all pass-through business income will be subject to Net Investment Income or the Self-Employment Contributions Act Tax (SECA). Meaning all trade or business income will be subject to the 3.8% Medicare surtax.

To ensure this happens, for tax filers with income above $400,000, the inclusion of gross income and gains from any trades or businesses otherwise not taxed would become subject to employment taxes. This would be a change to the current definition of what is included in Net Investment Income.

WHEN?:

There is confusion, due to multiple effective dates, as to when the proposed legislation for both long-term capital gains and qualified dividends will begin:

- April 28th, 2021---Date of Announcement of the American Families Plan.
- May 28th, 2021---Date of Publication of the American Families Plan.
- Future Date---- The date the American Families Plan passed legislation.

The likelihood of a retroactive start to either April or May appears the most plausible. However, Congress will ultimately have the final decision as to when legislation is effective. With half the year already behind us, there is a chance a retroactive start will not be in the cards.

WHERE DO WE GO FROM HERE?:

These proposed changes are comprehensive and have the potential to affect many individuals and business owners in multiple ways. We will continue to monitor the proposed legislation and provide updates as actual policy changes become more certain. In the meantime, if you have additional questions or thoughts on how these proposed changes might apply to a financial scenario, please do not hesitate to contact us.

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