Third Quarter 2021

The Coming Tax Tsunami

President Biden came into office with a very expensive agenda. Making that agenda a reality requires finding the money to pay for it. And therein lies what are arguably the most aggressive tax proposals since the Revenue Act of 1942. The Biden tax increases will theoretically affect only high-income households, are still just proposals, and must be enacted into law by Congress before they become a reality. The push to raise taxes is very real, however, and the potential for higher taxes should be a part of your investment considerations and planning for future income needs and your estate.

Top Marginal Income Rate

The Biden tax plan raises the top individual income tax rate for taxable incomes above $400,000 to 39.6%.

Capital Gains

The current long-term capital gains tax rates are 15%, 20% or 23.8% for higher income taxpayers. Under the Biden plan, for taxpayers with income above $1 million the long-term capital gains rate would mirror the top marginal income tax rate of 39.6%. When the Affordable Care Act's extra 3.8% for the Net Investment Income Tax (NIIT) is added in, this rate jumps to 43.4%. The Biden budget anticipates the capital gains increase beginning in late April 2021, indicating the rate is to be retroactive to prevent taxpayers from taking advantage of any gap before the tax increase started.

Death Taxes and Gift Tax

The Biden plan would eliminate the step-up in basis for inherited assets such as stocks, real estate and some other types of assets. A $1 million exemption per person is proposed before the elimination of the step-up in basis would take effect. Capital gains taxes would be owed at the time of inheritance, although some proposals would make them payable when the asset is sold. This might allow heirs to keep the family home a little longer. There are exemptions, yet to be clarified, for family-owned farms and businesses.

Campaign proposals also included expanding the estate and gift tax by restoring the estate tax exemption to the 2009 levels of $3.5 million per person or $7 million per couple.

Deductions

Itemized deductions for those earning more than $400,000, would be capped at 28% of value and the qualified business income deduction (Section 199A) would be phased out for filers with taxable income above $400,000.

Social Security Taxes

Plans include broadening the 12.4% Social Security tax, currently imposed on compensation income up to $142,800, to encompass all such income in excess of $400,000. This would leave a hole where income between $142,800 and $399,999 is not taxed for Social Security.

1031 Exchanges

Tax-free exchanges of real estate under IRC Section 1031 would be eliminated and the benefit of offsetting taxable gains by investments in “Opportunity Zones” is expected to be curtailed. These changes are in addition to a lengthy agenda for corporate taxation including increasing the corporate income tax rate from 21% to 28% and creating a minimum tax on corporations with book profits of $100 million or higher, structured as an alternative minimum tax.

State Taxes

State taxes add to the burden of higher Federal taxes. In 2020, states with the highest top income tax rates included California 13.3%; Hawaii 11%; New Jersey 10.75%; Oregon 9.9%; Minnesota 9.85%; District of Columbia 8.95% and New York 8.82%. Estate and inheritance taxes top out at 26% in Maryland. How those taxes might be impacted by capital gains taxes on inherited assets is anyone’s guess.

Managing your yearly income and the source of that income has always been important to minimize taxes on capital gains, Social Security income, and Medicare and estate taxes. Investors often spend too much time trying to optimize return or minimize expenses and overlook that the biggest impact to return is taxes. The proposed additional tax bite makes planning even more important, particularly if a transaction could put you over the $400,000 threshold; or wherever the higher tax bracket threshold ends up.

Brian R. Carruthers, CFP, CMT

BCA
BRIAN CARRUTHERS & ASSOCIATES

Your Conservative Advisory Firm Since 1990
301 Forest Avenue
Laguna Beach, California 92651-2115 USA
Telephone: 1-949-464-1900
www.gobcafunds.com
brian@gobcafunds.com