The impact of new tax laws under the Biden administration

How might the changes that are being proposed affect your taxes?

The administration of Democrat Joe Biden has now assumed control of the executive branch of the federal government. Democrats also retained control of the U.S. House of Representatives by a narrow margin and have gained virtual control of a Senate that is split 50-50, due to the tiebreaking vote of Vice President Kamala Harris.

This sets the stage for some potential major changes in tax policy, though early indications are that it may be several months before formal legislation can be enacted into law. Nevertheless, individuals should be prepared for the possibility of an altered tax landscape and the need to make appropriate changes to their wealth plan as a result.

As a general rule, most proposals are likely to be focused on the philosophy that corporations and wealthier Americans should shoulder a larger share of the nation’s tax burden. This will require reversing a number of tax policies that were implemented under the administration of President Donald Trump. In many cases, the new administration’s proposals are likely to be tied to expenditure plans, such as a renewed infrastructure investment program.

While details of President Biden’s tax proposals are yet to be finalized, in this paper, we’ll outline some of the most likely scenarios. Our goal is to help you begin to consider steps you may wish to take in the months to come.

Adjustments to the Tax Cut and Jobs Act (TCJA)
Many proposals coming from the Biden administration are likely to target policies established when the TCJA was passed in 2017. This was the major piece of tax legislation that set rates where they are today. Among the provisions included in this wide-ranging bill are:

- Revised tax brackets that resulted in lower tax rates for most individual income taxpayers
- A doubling of the standard deduction (in 2021, the standard deduction is $12,550 for single taxpayers and $25,100 for married couples filing a joint return), making the standard deduction the more advantageous option for most when filing taxes rather than itemizing deductions
- The elimination of personal exemptions (until 2017, taxpayers could claim a personal exemption, which in that year totaled $4,050, reducing their taxable income by that amount)
A $10,000 cap on deductions that can be claimed for state and local taxes

• A reduced long-term capital gains tax rate, with a significant number of taxpayers qualifying for a 0% capital gains tax rate

• A notable reduction in corporate tax rates

• The ability of certain business owners to deduct a portion of their income.

It is important to note that a number of the provisions in the TCJA are set to expire on Dec. 31, 2025. The Biden administration is likely to propose accelerating the sunset provision of the TCJA or making additional changes more quickly.

Key changes impacting taxes for individuals
An important marker laid down by candidate Joe Biden during the 2020 election is that those with incomes under $400,000 would not be subject to higher income taxes. In her confirmation hearings before Congress in January, incoming Treasury Secretary Janet Yellen indicated that this threshold would apply to households rather than individuals. We will have to wait to see if that benchmark is borne out when actual proposals are offered. It should also be noted that while the intent is to not to increase taxes on income under $400,000, the effect may be the opposite if there are any changes made to the TCJA or to accelerate the expiration of many of its provisions.

The most likely areas where changes could occur include:

• Upper end tax brackets adjusted to a higher rate. Those subject to paying income tax at the highest marginal tax rate are currently taxed at the 37% level. This was reduced in the TCJA from the pre-2017 peak rate of 39.6%. President Biden is likely to propose a return to a top rate of 39.6%. In 2021, this would affect individuals with income greater than $523,600 (or $628,300 for a married couple filing jointly). Other high-level brackets may be adjusted upward as well. Also under consideration is either a limitation on or the elimination of capital gains tax treatment for taxpayers earning $1 million or more.

• Renewed phase down of itemized deductions. This relates to the Pease limitation, a pre-2017 rule that phased down itemized deductions for those with higher income levels. The TCJA repealed the Pease limitation, putting no limit on itemized deductions regardless of income level. The Biden administration may propose limiting itemized deductions beyond the 28% tax bracket. This could result in a reduction of the itemized deduction benefit by 11.6% for those earning more than $400,000 per year.

• Change to state and local tax deduction. Those who are subject to state income or sales taxes saw the benefit of this once unlimited itemized deduction reduced under the TCJA. It capped deductions on real estate and personal property taxes, along with either income or state sales tax deductions to $10,000. For those living in states with high property taxes and high income or sales taxes, the limit resulted in a higher federal income tax bill. Biden may propose repealing this change, and reinstating the pre-TCJA unlimited deduction for these state and local taxes.

• Adjustments to tax credits. Tax credits provide a dollar-for-dollar reduction in taxes owed. Proposals are being considered to expand eligibility to claim a tax credit for health care premiums, provide a credit for first-time homebuyers, increase the child/dependent care tax credit and restore residential energy efficiency credits and electric vehicle tax credits.

• A boost in the capital gains tax rate. Currently capital gains tax rates are taxed at the rate of 0%, 15% or 20% depending on your marital status as well as your taxable income. Note that a 3.8% Net Investment Income Tax (NIIT) also applies to higher NIIT earners, which could result in a combined long-term capital gains tax rate as high as 23.8%. For taxpayers with incomes over $1 million, long-
term capital gains and qualified dividends would be taxed at their ordinary income tax rate. If current laws are changed, this could be at the 39.6% tax rate, plus the 3.8% NIIT (applicable to higher income taxpayers) for a combined rate of 43.4%.

- **Changes to the Social Security tax.** In 2021, Social Security taxes (6.2% for individuals, a matching 6.2% for employers) are applied to wages up to $142,800. Incomes above that threshold are not subject to Social Security tax (note that the 1.45% Medicare tax applies to all wages). One proposal is for the Social Security tax to also apply at higher income levels, perhaps for incomes of $400,000 and greater.

**Potential changes to taxes for businesses and business owners**

Another likely target of the President’s proposals are taxes on businesses and business owners. Among the notable changes made in the TCJA of 2017 was a reduction in the corporate income tax rate from 35% to 21%. Here are potential changes that could be on the table in legislation that comes before Congress this year:

- **Elimination of deduction for pass-through entities.** The TCJA implemented the ability for owners of sole proprietorships, partnerships, S-Corporations and LLCs to claim a 20% tax deduction for qualified business income. This is likely to be eliminated in the next wave of tax legislation for those earning more than $400,000.

- **Change in the corporate tax rates.** The current 21% corporate income tax rate may be raised to 28%. Also, companies that are subject to the Global Intangible Low Tax Income tax of 10.5% may see it increase to as high as 21%. Also under consideration is a 15% minimum income tax on financial statement profits on companies with more than $100 million in net book income that might otherwise not be taxed.

- **Other provisions that affect specific industries.** A range of proposals is being considered, including a financial risk fee on financial institutions with more than $50 billion in assets, eliminating the tax deduction for the costs of direct-to-consumer prescription drug advertising, imposing a tax on pharmaceutical companies if drug price increases exceed inflation, and an expansion of clean energy tax initiatives.

**Estate planning changes**

The TCJA of 2017 made dramatic changes to estate tax laws that affected high net worth individuals and families. Most notably, it doubled the unified gift and estate tax exemption. However, changes such as these are scheduled to phase out after 2025, but again may be targeted for modification in the near future by the Biden administration. We may see:

- **A reduction in the unified gift and estate tax exemption amount.** In 2021, the exemption is $11.7 million for an individual, or an effective $23.4 million for married couples. This amount is indexed every year for inflation. Under current law, the exemption amount reverts to what it was in previous times, at approximately $6 million for an individual and $12 million for a married couple, beginning in 2026. President Biden has supported returning estate tax exemption amounts to 2009 levels, approximately $3.5 million per taxpayer. This could expand the impact of estate taxes to a much larger percentage of families.

- **Change in the step-up in cost basis for inherited assets.** Laws have long been in place related to inherited assets, such as stock or real estate that are passed on from one individual to another at death. Under current rules, the cost basis of an inherited asset is “stepped up” from the price initially paid by the deceased individual to the value at the time of that person’s death. So an asset that was originally purchased for $10,000 that was valued at $25,000 at the time of the owner’s
death would be considered to have a revised cost basis of $25,000 for the beneficiary. Proposals are being considered to eliminate this provision and require that the initial cost basis continue to apply, which could have significant tax consequences for those who stand to inherit assets. Alternatively, it is possible that any gain on the inherited asset could be taxed at higher, ordinary income tax rates instead of the more favorable long-term capital gains tax rate.

Estate planning is particularly important today in light of these potentially significant changes. For example, if changes in the step-up in cost basis occur, the transfer of a family business could be more significant tax consequences. A solution to deal with these possible new rules is to sell the business, or an interest in the business, to a family member or irrevocable family trust. This results in a new, upwardly adjusted cost basis equal to the purchase price. Life insurance may also play a role, as the policy death benefit would receive a "step-up" in cost basis upon the death of the insured, and proceeds from the policy's death benefit would be received income tax free by the policy's beneficiaries.

How markets may react to changing tax laws
Given a number of other priorities including a focus on dealing with the COVID-19 pandemic and the continued economic fallout from it, tax policy changes may not be seriously considered until later this year. Even with Democratic control of the House and Senate, major tax policy legislation is likely to face many challenges in Congress. This could result in more measured proposals. Yet even if Congressional action doesn't happen soon, there is the possibility that some laws passed late in 2021 could apply retroactively to the start of the year.

In light of this, markets may not feel an immediate impact from the presence of a new administration. Investor reaction to tax proposals is not easy to predict. It is possible that significant increases to both individual and corporate income tax rates at the same time will have a temporarily negative impact on the markets. At the same time, if changes to tax policy include increased government spending in areas like infrastructure improvement, it could provide a boost to the market.

Assuming the COVID-19 pandemic is brought under better control in the months ahead, the economy should begin to return to what is referred to as a "steady state." As a degree of normalcy emerges, we should expect the economy to continue to grow, and that would likely be favorable for the markets. However, some segments of the economy may benefit more than others given changes in consumer habits and business practices that have occurred since the start of the pandemic in early 2020. This could benefit certain companies and industries while having a negative impact on others.

Individual investors should carefully consider the potential for changes to long-term capital gains tax rates as they assess their own portfolios. While no "buy and sell" decisions for your portfolio should be made strictly on the basis of tax consequences, it is an important factor, particularly if changes to tax laws are a possibility. If you hold appreciated assets that you are considering selling, you may wish to lock in those gains before any potential tax increase is applicable.

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