knowledgeable thoughtful ethical experienced interac

summaries

SIGMA INVESTMENT COUNSELORS

the official newsletter of sigma investment counselors November 2020

WHAT A BIDEN PRESIDENCY COULD MEAN FOR YOUR TAX BILL

During his presidential campaign, Joe Biden promised the public that he would raise taxes on high-income households. His definition of "high-income" is income for a household that exceeds $400,000 a year. Now that Biden has won the election, let us take a close look at a few highlights of Biden's overall tax plan.

Households who make more than $400,000

First, Biden wants to revert the top individual income tax rate for income above $400,000 from 37% to 39.6%. Essentially, he wants to undo what Trump's tax cuts did in 2017.

Furthermore, under current tax law, any wages above $137,700 aren't subject to the 12.4% Social Security payroll tax (half paid by the employee; half paid by the employer). Biden proposes that anyone whose wage is over $400,000 should also be subject to the 12.4% Social Security payroll tax. However, this proposal would create a "donut hole," leaving wages between $137,700 and $400,000 not subject to payroll taxes.

A small business owner who earns $400,000 or more might also see a tax increase by losing a valuable deduction. The current tax code allows small business owners to add a 20% deduction for "qualified business income" from pass-through entities (e.g., partnerships, S corporations, and limited liability companies). Biden supports phasing out this deduction if a small business owner makes more than $400,000 for the year.

Capital gain taxes

Today, capital gains from the sale of a capital asset that the owner holds for less than one year are considered short-term capital gains and are taxed as ordinary income. If the holding period is more than one year, the capital gains will be treated as long-term and taxed at a 20% rate if the owner is a single filer with taxable income over $441,451 or a married couple with taxable income over $496,601. Under the new proposal, Biden wants anyone who earns more than $1 million per year to pay tax on capital gains at the top ordinary income tax rate, which under the new tax plan, will be 39.6%. In other words, the capital gains tax rate for a top earner could potentially be doubled.

Biden's tax plan might also affect the taxation of capital gains at death. The current tax code requires the cost basis, or purchase price, of a capital asset to be updated to the market value at the owner's date of death. In other words, unrealized capital gains will be reset to zero on the date of death, and tax will be owed only on appreciation after that. For instance, your mom bought a few shares of AT&T stock ten years ago, and at the time, her cost was $50,000. At her death, those shares are now worth $80,000. You inherit those shares and your cost basis will be the market value of $80,000 at the date of the death. If you sold the shares right away, you would not owe any tax.

Biden's proposal calls for eliminating the "step up" method to calculate cost basis for inherited capital assets. Under the Biden plan, the heir would inherit a capital asset and accrued capital gains. In this instance, you would "inherit" you mom's cost basis of $50,000, and if you sold the shares for $80,000, you would owe taxes on the capital gains of $30,000.

Itemized deduction

Another Biden idea is to cap the value of itemized deductions at 28% for those who make more than $400,000. Biden plans to reduce the total amount of itemized deductions for anyone whose marginal tax bracket is above 28% – that is, taxpayers in the current 32%, 35%, 37% tax bracket, or the proposed 39.6% bracket. For example, if a top earner makes a charitable gift, instead of getting a 39.6% tax reduction for every dollar spent on the donation, he would only get a 28% tax reduction for every dollar donated to the charity.

Estate tax exemption

The current estate tax exemption amount is $11.58 million, and Biden wants to reduce the exemption amount. Although he hasn't said how low he'd like it to go, we think he'll probably try to set the exemption amount to around $5.5 million. That means any estate worth between $5.5 million to $11.58 million would be hit with an estate tax rate of 40% if Biden's plan is implemented, while previously there would be zero estate tax in that range.

We also need to recognize that two Senate seats remain available. The fate of the Biden tax plan will not be clear until after the January runoff election in Georgia. If the Republicans maintain control of the Senate, tax reform will be difficult to push through Congress in 2021. Besides, Biden's priority is to tackle the pandemic and economic fallout instead of raising taxes.

Having said all that, tax planning is all about thinking ahead. If Biden's tax reform concerns you, please discuss with your advisor ways to handle your 2021 finances in a tax-efficient way.

Wenma Gorman, CFA, CFP®