Potential Tax Implications of a Biden Administration

High income earners and businesses may see a drastic increase in income tax under a Joe Biden Administration

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With Joe Biden elected president, and a Democratic majority in both the House and Senate, taxpayers are likely to see a change in tax law over the next few years. As laid out in his presidential campaign last year, Joe Biden proposes various changes centered around raising taxes on higher income earners and businesses. With these changes, Biden hopes to raise as much as $3.7 trillion in additional tax revenue over the next 10 years. It is unclear which proposals will take priority and when they could take effect, however, taxpayers should familiarize themselves with his plan now should any of his ideas get pushed through to Congress.

INCREASE IN INDIVIDUAL TAX

One of the key changes proposed by Biden is an increase to individual income and payroll tax for individuals with income over $400,000. He would essentially eliminate the 37 percent ordinary income tax brackets and revert the top rate to 39.6 percent. He also intends to impose the 12.4 percent social security tax on wages above $400,000, to be evenly split between the employer and employee. Currently, only the first $142,800 (the current wage cap for 2021) is subject to social security tax. Biden's plan would create what some are referring to as a "donut hole", but perhaps not in the traditional way we think about it, like Medicare for example. In this instance, wages between $142,800 and $400,000 would not be subject to social security tax. Additionally, Biden intends to tax long term capital gains and qualified dividends at the top ordinary tax rate of 39.6 percent for individuals with income over $1,000,000. Currently, all long-term capital gains and qualified dividends for high income earners are taxed at a maximum rate of 20 percent (not including the net investment income tax of 3.8 percent), so this would be a drastic change for those individuals which could accelerate the timing of future sales.

LIMITATIONS ON INDIVIDUAL TAX DEDUCTIONS

There are several changes in Biden's tax plan related to the deductions currently allowed to be claimed by an individual taxpayer. First, he plans to implement a phaseout of the qualified business income deduction for filers with taxable income above $400,000. This is on top of the deduction phaseouts currently in place as described in provision 11011 of the Tax Cuts and Jobs Act (TCJA). Biden also plans to restore the Pease limitation on itemized deductions, which was suspended in the TCJA. The limitation reduces a taxpayer's itemized deduction by the lesser of 3 percent of income over a specified threshold, or 80 percent of total itemized deductions. On top of the Pease limitation, the tax benefit of all itemized deductions will be capped to 28 percent of their value for taxpayers whose income exceeds $400,000. Currently, we assess the value of a deduction at our marginal tax rate. For example, an individual in the 32 percent tax bracket who itemizes on their return would receive a benefit equal to 32 percent for each additional dollar claimed as an itemized deduction. Under the proposed changes, the benefit would be limited to 28 percent of the deduction value. Introducing a cap has the potential to change taxpayers' decision-making around costs like mortgage interest, or more often analyzed, charitable giving to non-profit organizations. When the standard deduction was raised under the TCJA, many analysts thought there would be a sharp decrease in donations, but research shows Americans are giving almost as much as they ever were, with 2019 being the second highest year on record for giving, even after adjusting for inflation. A surprising counter to some of these limitations is Biden's intention to eliminate the state and local tax (SALT) cap. The $10,000 limitation ($5,000 for married couples filing separately) on state and local income and property tax deductions was introduced in the TCJA and predominantly impacted taxpayers earning income in the top 1 percent. The repeal of the cap would provide for a larger tax deduction but would still be subject to Biden's other proposed limitations previously discussed.

EXPANSION OF INDIVIDUAL TAX CREDITS

While the majority of Biden's plan is to increase tax rates for those with higher income, he is also introducing new tax credits, as well as increasing the value of credits currently available to individuals. To start, first-time homebuyers may be eligible for a First Down Payment Tax Credit worth up to $15,000 which would help cover the initial costs and fees associated with purchasing a new home. We saw a similar credit in the Housing and Economic Recovery Act signed by President Bush in July of 2008; however, this expired in 2010. Additionally, he would temporarily increase the child tax credit. Currently, parents can claim a $2,000 tax credit for each qualifying child under age 17. Biden would increase the credit to $3,000 per qualifying child for children ages 6 to 17 and to $3,600 for children under age 6. He would also increase the child and dependent care credit from the maximum amount of $2,100 to $8,000. Under the current TCJA rules, the maximum care credit is equal to 35 percent of up to $3,000 in qualified expenses ($6,000 for two or more dependents). Under Biden's plan, the percentage would increase to 50 percent and the maximum in qualified expenses on which the credit is based would be increased to $8,000 ($16,000 for two or more dependents). Of course, the eligible credit would be phased out for individuals with higher income as is the case currently. Amongst the other changes in Biden's plans is the expansion of the earned income tax credit for childless workers aged 65 and up, the reinstatement of the full electric vehicle tax credit and the expansion of the Affordable Care Act's premium tax credit. He has also suggested the creation of an informal caregiver credit as well as a refundable tax credit for low-income individuals and families.

CHANGES FOR REAL ESTATE INVESTORS

Investors in real estate may also experience a significant tax hit as Biden's proposal includes eliminating a tax break that has been available to the real estate industry for decades. Eliminating the 1031 exchange, commonly known as a "like-kind exchange", would be responsible for a large portion of his tax revenue goal. This section of the Internal Revenue Code allows real estate investors to defer recognition of a capital gain on the sale of business property by investing the proceeds into another business property. While 1031 exchanges have been challenged in the past, many experts still believe its elimination has the potential to discourage further investment which could drastically impact the economy. Biden also intends to eliminate the $25,000 exemption from the passive loss rules for rental losses. This rule allows lower income taxpayers to deduct up to $25,000 of passive losses from rental activities against their other, nonpassive income. Without this exemption, any losses sustained by a non-real estate professional on a rental property will be subject to the passive activity loss rules, where passive losses in excess of passive income are disallowed and carried forward to future tax years.

ESTATE TAX CHANGES

Amongst Biden's tax plan are a few changes related to the way estates are taxed. The first is a reduction of the estate tax exemption from the current $11.7 million per person. His proposed exemption amount is unclear; however, this reduction would also mean a decrease in the lifetime gift exemption, which is the amount you can give to third parties during your lifetime without paying gift tax. Biden has also proposed an increase in the estate tax rate from 40 to 45 percent and suggested the elimination of the step-up in basis at death. This has the potential to drastically decrease the value of assets ultimately received by heirs. Details on how the removal of the step-up in basis would be applied are unknown, however, some experts believe this could be enforced in one of two ways. When an individual inherits appreciated property, either the decedent will recognize a capital gain on their final income tax return with the estate paying the associated tax, or the heir will receive a carry-over basis equal to the decedent's original purchase price, and the gain recognized upon the later sale. Other experts believe officials could land on a limit on the step-up in basis, as opposed to a full elimination. This is similar to the modified carryover basis rules that applied in 2010, where property acquired from a decedent would receive a partial step-up in basis, limited to a specified amount. Regardless of how implemented, these proposals could mean a significant increase in tax and a drastic change to wealth transfer planning.

BUSINESS TAX CHANGES

In December of 2017, U.S. corporations received a significant tax break with the passing of Trump's TCJA, decreasing the top corporate income tax rate from 35 percent to 21 percent. Biden, however, intends to increase the corporate tax rate to 28 percent. Additionally, the TCJA eliminated the federal AMT (Alternative Minimum Tax) for corporations; however, Biden has proposed reinstating the AMT in a different way. His version will assess a corporate minimum tax of 15 percent on *book income* of $100 million or more, while still allowing deductions for net operating losses (NOLs) and credits for foreign taxes paid. To counter some of these changes, the Biden team has released their proposals to attract and retain investment in the United States. Among these proposals are a 10 percent tax credit for certain businesses that are struggling with domestic operations, incentivizing recently closed facilities to re-invest in production and job creation. Biden would also implement stricter rules for companies that operate through a foreign affiliate.

While President Biden has stated his intent to make various other changes in the tax code, the provisions mentioned above will provide for the majority in tax revenue and will likely have the largest impact on those with higher income. With a reform in tax law likely to occur, the question remains as to when these proposals could take effect and to what extent. As we have seen in the past, legislation can be enacted retroactively if doing so is rationally related to a legitimate legislative interest. Therefore, it is very possible that any legislation passed could apply to the 2021 tax year, limiting a taxpayer's ability to front run changes. A change in tax law also requires compromise, so it's possible some of these proposals are modified, or put to bed entirely. Individuals should take the time to fully understand Biden's proposal and the impact it may have on both themselves and their businesses.

It is important to consult with your tax and legal advisors when applying potential changes to your own situation.