Integra Capital ADVISORS | Tax Planning

BIDEN TAX PLAN

An outline and analysis of President Biden's proposed tax plan issued during the Presidential campaign with a focus on provisions that may impact individuals and small business owners.

Brad Campbell, CLU, ChFC, Mtax, CFP®, CFA®
Executive VP | Chief Investment Officer

WHY ARE TAXES SO IMPORTANT?

Taxes of all forms (federal income taxes, state income taxes, sales taxes, real estate taxes, investment taxes, estate taxes, etc.) account for the largest transfers of wealth we make during our lifetimes, and sometimes upon death.

While taxes provide sources of revenue for national, state and local governments to provide shared infrastructure and services, such as roads, bridges, schools, parks, military defense and various social safety net programs, it's important to understand the impact of such taxes on you and your family. Afterall, the more families and individuals prosper, the greater the volume and magnitude of economic transactions. As famed hedge fund icon, Ray Dalio, of Bridgewater Associates, puts it in This animated video, *How The Economic Machine Works*, **"the economy is merely the sum of the transactions that make it up."**

In this analysis, we explore the Biden-Harris tax plan as proposed during their general election campaign. Our analysis will focus primarily on proposed provisions that impact individuals and business owners directly.

Payroll Taxes

New Provision: Add a 12.4% Social Security payroll tax (employer pays half, employee pays half) on income earned above $400,000.

Current Situation: Social Security payroll taxes of 12.4%, split equally between employer and employee, are levied on wages up to $142,800 in 2021. The Medicare tax of 2.9% is split between employers and employees on all wages with no cap.

Comments: Status quo for Social Security taxes withheld from wages and matched by employers up to $142,800. Payroll tax hole created for wages above $142,800 and up to $400,000.

This policy likely is designed to salvage the underfunded Social Security trust, placing more burden on the highly compensated.

The policy, if enacted, will impact highly compensated employees of large corporations more than small business owners with net incomes above $400,000. Corporate executives and upper management who earn high wages are receive most of their compensation via W-2 reported wages, thus subjecting most of their compensation to the new proposed payroll tax as well as their respective employers. Small business owners, particularly single owner businesses, have more flexibility in determining the balance between paying themselves W-2 salary and profit distributions, with distributions not subject to payroll tax.

Real Estate

New Provision: Biden's published plan and subsequent verbal comments have been a bit vague regarding the taxation of real estate. However, an analysis by accounting firm, Deloitte, *A change in course; Tax policy implications of a Joe Biden Presidency*, interprets the intent of his tax plan to repeal the like-kind property exchange rules currently found under Internal Revenue Code Section 1031 ("1031 Non-taxable Exchanges").

Current Situation: Real estate investors may currently defer capital gains taxes on the sale of real property by identifying and investing in like-kind property of equal or greater value under IRC §1031, as long as certain parameters are met.

Comments: Real estate owners often engage in non-taxable like-kind exchanges for tax planning purposes. The most common strategy is the scenario where the cash proceeds from the sale of appreciated property are not currently needed, so the capital is reinvested to generate income for retirement or general living standards. The professional real estate investor may have a different angle. Perhaps another attractive real estate investment opportunity is identified and the proceeds from another sale of appreciated property is sufficient to purchase the new property in whole or in part.

In either scenario a greater capital base is preserved, at least temporarily, to reinvest in the new property. A higher level of income may be earned with the larger purchase amount due to avoiding capital gains taxes.

As with any change in tax policy, the provision here is designed to increase the amount of current taxable income realized to increase federal tax revenues today, by removing the deferral for a later date.

The assumption here made by the Biden tax policy authors is that real estate owners will indeed move forward with the sale of real property even though the ability to defer the taxes on such a transaction has been eliminated. No transaction, no tax revenue.

Will an even lower supply of real estate trigger a supply and demand dislocation and drive the price of real estate up even higher if sellers become reluctant to realize gains today rather than continue to hold their current investment property? Time will tell.

Ordinary Income Tax Rates

New Provision: Return the top marginal tax rate to 39.6% for income above $400,000.

Current Situation: Top rate of 37% through 2025 on income greater than $518,401 for individual filers and greater than $622,051 for married filing joint filers.

Comments: I think this one speaks for itself and is consistent with the overall theme of the Biden tax plan; shift more of the burden on those Biden and his advisors deem "wealthy" among us.

However, it is interesting to note that Biden's tax plan is largely comprised of more traditional notions of tax reform. Unlike others in his party, in particular the Senator from Vermont, Bernie Sanders, absent from Biden's plan is the "wealth tax", or the tax on a taxpayer's accumulated net worth.

Capital Gains and Dividends

New Provision: Subject realized long-term capital gains and dividends to tax at ordinary income tax rates for those with taxable income greater than $1 million.

Current Situation: Realized long term capital gains and qualified dividends are taxed at 20% regardless of a taxpayer's effective ordinary income tax rate. An additional 3.8% "net investment tax" also applies to higher income earners ($200,000 plus for individual filers and $250,000 for joint filers). Deloitte and other commentators interpret the new tax provision to also apply to the sale of qualifying personal residences where significant tax breaks currently exist for homestead real estate held for longer than 2 years.

Comments: I would not be surprised if the taxable income threshold that triggers the increase in tax was lowered to the popular $400,000 level.

One potential flaw in the provision Biden and his supporters seem to have ignored, or not taken into account, is that a large one-time transaction, such as the sale of a residence, can increase taxable income in the year of the sale to top tax rate levels never before reached by a taxpayer, thus ensnaring the middle class wage-earner in a provision seemingly not intended to be impact this class of taxpayer.

I also wonder if the elimination of tax preferential treatment on capital gains will cause wealthy investors, who do not have an immediate need for the capital to simply hold all long-term investments while they await a more favorable tax regime. If they do, and they certainly have that luxury, this provision would not raise significant revenue.

Itemized Deductions

New Provision: Restore the Pease limitation on the deductibility of itemized deductions for those taxpayers with income greater than $400,000. In addition, cap the value of itemized deductions at a maximum of 28% of income.

Biden's position on state and local tax deductions (SALT) is not completely clear at this point.

Current Situation: Under current tax law, taxpayers may deduct the greater of the standard deduction (which was doubled as part of the Tax and Jobs Act of 2018) or the sum of itemized deductions with no cap under the former Pease limitation, which limited the use of itemized deductions when income exceeded certain thresholds.

SALT deductions are currently limited to $10,000.

Comments: The itemized deductions section on the U.S. federal income tax return has often been used to either incentivize certain financial behaviors (home ownership, charitable contributions) or provide relief for certain hardships (dramatic increase in health and medical related costs incurred relative to income level).

It has been my experience that many middle-income taxpayers have either not benefited from President Trump's handling of itemized deduction limitations and the increased standard deduction or have been negatively impacted by the current provisions. This is a broad stroke comment though and it depends on the individual taxpayer's situation.

Child Tax Credit

New Provision: Increase credit amount to $3,000 per child (age 6 to 17), and to $3,600 for those under 6. Make credit "fully refundable". Continue in 2021 and beyond as necessary given economic conditions from pandemic.

Current Situation: $2,000 credit for children 17 and younger, but subject to adjustments for those whose gross adjusted gross income (AGI) exceeds certain thresholds.

Comments: This provision is obviously designed to target families burdened with higher expenses due to the pandemic and homeschooling children while they work from home and so forth. Of course, it is meant to be temporary and still subject to the AGI limitations so as to not award credits to higher income taxpayers.

"Fully refundable" means that you don't have to have a federal income tax liability to apply the credit or partial credit against. If your federal income tax liability after retirement plan contributions, itemized deductions or standard deduction and so forth is zero, you would still receive a refund from the credit.

Child and Dependent Care Tax Credit

New Provision: Increase max credit amount for the cost of childcare to $8,000 for one child and $16,000 for two or more children. Phase out starting at AGI of $125,000 and elimination of credit at $400,000 AGI.

Current Situation: Non-refundable credit for 20 to 35% of the cost of work-related care, up to $3,000 per child younger than 13, or $6,000 for 2 or more. Phased out for households with AGI greater than $43,000.

Comments: First, a "non-refundable credit" means if before considering the Child and Dependent Care Tax Credit you have zero tax liability then the credit is essentially irrelevant (you receive no additional benefit from the credit). It's quite obvious the dependent care tax credit was never intended for upper income households. The Biden tax plan continues this theme but does increase the beginning phaseout threshold from $43,000 to $125,000.

Earned Income Tax Credit

New Provision: Expand the eligibility rules to include workers (those still employed or self-employed) age 65 and older.

Current Situation: Fully refundable tax credit available to individuals with low to moderate income from wages. There are several limitations due to income limitations and other parameters beyond the scope of this analysis.

Comments: To me this is a very sensible policy item. It modernizes the earned income tax credit in acknowledgement of the everchanging dynamics of work versus retirement.

Family Caregiving Incentives

New Provision: Tax credit of up to $5,000 for "informal caregivers" to cover expenses incurred in caring for other family members such as the elderly or those with disabilities, chronic health conditions or military service members dealing with related physical and mental issues.

Current Situation: Nothing under current tax law.

Comments: As our population lives longer and as veterans come home from serving in dangerous places like the Middle East, this has become in an increasingly significant issue and I am all in favor of providing financial support for those families impacted by such situations. I believe the Republicans would have eventually come out with a similar policy position anyway. This may be the most non-controversial proposed provision in the Biden Tax Plan.

Retirement Savings

New Provision: Deloitte and others simply state that the Biden tax plan seeks to "equalize" tax treatment of defined contribution savings accounts. There is also language in the plan that makes it obvious the intent to allow informal caregivers, who perhaps have left the workforce to care for aging parents or family members with disabilities or returning veterans, to make contributions to retirement accounts even though they

do not receive a "wage" in the traditional sense of the notion. Biden also includes a provision to allow victims of domestic abuse to access retirement account funds without the standard early withdrawal penalty but there is no mention of the taxation of such withdrawals as of yet.

Current Situation: There are several widely known, rules and limitations for contributions to retirement accounts so I won't list all of them here as most are already fairly familiar with these provisions.

Comments: The topic of "retirement savings" initially got me excited to see what might be in the plan. However, as I read through the analysis by several firms, I quickly realized Mr. Biden doesn't seem to have given this area much thought at this point. But I will say that retirement account rules are often used to control the ebb and flow of tax revenues. A good example is the Roth IRA. At the time Congress was looking to raise federal tax revenues immediately. Whenever the government gets hungry for more revenue, they first look at the larger numbers. At the time tax deferrals into retirement plans such as 401(k)s and traditional IRAs presented the best opportunity. So, Senator Roth came up with an idea that would incentivize people enough to subject more of their current income to current taxation and in return receive tax free withdrawals later in life.

Estate Tax

New Provision: A "return of the estate tax to 2009 levels". In 2009, the top estate transfer tax rate was 45% and the amount of the estate tax exemption was $3.5 million per taxpayer indexed annually for inflation.

The proposal also includes the elimination of stepped-up basis valuation as of date of death.

Current Situation: Today, the basic estate exclusion is $11.7 million per individual resulting in a $23.4 million estate tax exclusion for a husband and wife annually indexed for inflation since the institution of the current tax regime for estates. The current law is set to sunset on December 31, 2025.

Inheritors of assets currently enjoy a stepped-up tax basis using a date of death valuation.

Comments: This is a big one folks. I think the probability of this one becoming law is quite high. It is a tax that impacts wealthier families and plays well in politics. History also tells us that families at these levels of net worth often have good advisors to help them navigate the estate transfer tax using a variety of available planning tools depending on the particular situation. It will also bring estate tax planning back in vogue in the financial planning world since a larger number of estates will be subject to the tax for the first time in many years.

Alternative Energy Consumer Incentives

New Provision: Basically, all of Mr. Biden's proposed policy provisions are centered around *restoring* alternative energy incentives as they were during the Obama administration; a full electric vehicle (EV) tax credit but modify it to focus on middle-class consumers and incentivize the purchase of American-made vehicles. This restoration project also includes tax credits for residential energy improvements (think solar panels, high efficiency water heaters and HVAC systems, etc.). And then of course there is a provision for solar power, an often highlighted piece of the Biden initiatives overall. He seems to like the idea of permanently extending the solar investment tax credit (ITC).

Current Situation: Tax credit of between $2,500 and $7,500 for new EV purchase. Tax credit for 10% of the cost for installing qualifying energy efficient equipment in your home, up to a $500 credit. 26% investment tax credit (ITC) for installing renewable energy systems in your home; with the credit good through 2021. Subsidies paid by utility companies to residential customers who invest in energy conversation measures are excludable from the consumer's income for tax purposes.

Comments: Regarding the residential tax credit provision, I think people need financial incentive to invest in these types of energy efficient measures, otherwise most people won't even consider it, just the programmers out in silicon valley and the Hollywood types who can afford it either way.

Overall, clearly, taking action to combat climate change and shift to renewable energy is one of the most

significant platforms of the Biden campaign and his administration. I would expect these provisions and more along the way. Let's just hope they make good sense.

Housing Costs

New Provision: Advanceable and refundable First Down Payment tax credit of up to $15,000. Renter's tax credit intended to reduce rent and utilities to 30% of income for low-income households. Tax credit for families that renovate properties in distressed communities. Interestingly, Biden's position on SALT deductions is not clear but most feel like he favors the repeal of the current limitations.

Current Situation: President Trump's Tax and Jobs Act limited the home mortgage interest deduction to interest paid on up to $750,000 of mortgage debt incurred to acquire a home ("acquisition indebtedness"). Trump's Tax and Jobs Act also limited the SALT deduction to a max of $10,000, which is scheduled to remain through 2025.

Comments: I am always generally in favor of policy that encourages an increasing number of economic transactions, the engine of any economy. I was not in favor of these particular provisions of President Trump's Tax and Jobs Act and still do not favor them. The provisions disincentivize wealthier people from obtaining mortgages on property that would otherwise qualify for the deduction, especially given the elimination of the Pease limitation on itemized deductions.

Even though Mr. Biden seems to say he favors repeal of the SALT limitations, I have to think, given his overarching desire to hit those households earning more than $400,000, there will likely be limitations for higher income households. I wouldn't get your hopes up here if you own a higher valued home and would like to obtain a mortgage at today's low rates and be able to deduct the interest you pay. That is, unless the price of your home is disproportionately large relative to your taxable income.

Health Care Costs

New Provision: Expand ACA tax credit by eliminating income cap, capping premium spending at 8.5% of income and increasing the credit amount.

Expand tax benefits for those who pay for long-term care insurance with retirement savings.

Current Situation: Refundable and advanceable premium tax credit for those enrolling in ACA marketplace plans who have income 100% to 400% of the federal poverty level for a given household size. Cap on premium spending based on income (top rate of 9.78% in 2020).

Long-term care insurance premiums includable as an itemized deduction under the health care costs line item but subject to the 7.5% of AGI floor.

Comments: I am certainly of the opinion that we have big problems with our current health care system. I also readily admit the problems are extremely complex with domino effects it takes a sophisticated computer program to sort through. There are so many competing interests, both financial and human interests at stake. Tackling what's wrong with health care and how to fix it is way, way beyond my scope of expertise. However, I will share a few anecdotal comments.

Good doctors have been forced to join huge physician corporations, causing the near end of the "family doctor", sole practitioner practice that I really favor. 60 Minutes featured a massive hospital corporation that has taken over the health care system in California allowing it to persistently and dramatically increase prices every year with no system of checks and balances, and more importantly, with no other underlying rational other than profit optimization. I also think the pandemic has shown us what a "just in time" system of health care really looks like. No inventory of medical devices and supplies, and total lack of planning and preparation from a personnel and staffing standpoint. This takes nothing away from the wonderful health care professionals who work within these systems, rather it is a critique of the systems and corporations themselves.

Any small business employer will tell you the cost of doing business he or she dreads the most is the cost of group health insurance benefits for employees. Employees expect this benefit as a minimum standard but fail to understand just how high the costs are and do not incorporate the total value of these benefits in their overall compensation package. It's just human nature.

Long-term care expenses are high and growing. However, the long-term care insurance industry blew itself up many years ago. They came to market and promptly competed with each other on price. A tact that was a mistake causing many to go out of business. Today, that leaves the marketplace with only a few insurers that still offer policies that cover non-skilled custodial care. The tax deduction for long-term care insurance premiums became totally irrelevant to most taxpayers. I like the Biden Tax Plan idea of providing some sort of tax incentive for those people who pay for long term care insurance with distributions from retirement plans. We already have such a provision for direct contributions to charities from IRA accounts. This may incentive, or make affordable, the purchase of long term care insurance and prevent more and more people from intentionally qualifying for Medicaid, saving the states a lot of money that could be spent on improving public education and other initiatives.

Tax-Preferred Savings Vehicles for Health Care: Disability Expenses

New Provision: This topic only receives a modicum of attention from the Biden plan. He supports expanding the eligibility rules for ABLE accounts, which blind or disabled people can use to make tax-deferred contributions to fund future qualifying expenses related to their blindness or disability. Biden's proposal effectively expands the scope of who may use these accounts by making anyone who develops blindness or disability before the age of 46 eligible.

Current Situation: Medical savings accounts and health savings accounts (MSAs and HSAs) that allow people with a qualifying health plan coverage to save on a tax deferred basis for future healthcare expenses.

The current limitation for saving in an ABLE account is to become blind or disabled prior to reaching age 26.

Comments: This topic goes hand in hand with the overall issue of health care and I will leave it at that.

Higher Education Expenses

New Provision: Wants to relax the income-based repayment formula for undergraduate federal student loans while also providing loan forgiveness after 20 years for borrowers with good repayment history and does not want the forgiveness of debt to be imputed to the borrowers as taxable income.

Current Situation: Above the line tax deduction (where you deduct contributions to IRAs and the like) for interest on student loans for those with MAGI (modified adjusted gross income) below $80,000 and joint filers below $160,000.

Most indebtedness forgiven is included as taxable income, and this includes any forgiveness of student loans, with narrow exceptions.

Comments: Mr. Biden seems to want to do something about the debt some of these students have incurred for their college education. What Mr. Biden seems to have missed is that many of these student loans have been securitized in "asset-backed" loans and sold to investors. Forgiving loans which have been sold to investors is a complicated situation since these investors deserve payments. Hopefully this will be given careful consideration before anything is codified in legislation.

Reform of our education system needs to start somewhere else other than student loans and loan forgiveness. The new administration should focus on fundamental reforms to improve the current system.

Summary Comments

In my view the Biden Tax Plan, at least those provisions proposed in his campaign platform and discussed during debates and public appearances, seems to be more moderate than expected. The President-elect's tax policy proposition utilizes what I will characterize as "traditional" methods to incentivize, reward, assist and fund. I think many who identify as conservatives feared provisions such as the "wealth tax" put forth by the likes of Elizabeth Warren and Bernie Sanders. There is no trace of a wealth tax in the plan as we read it today. The magic number for the Biden plan seems to be $400,000. Many proposed tax increases or credit and deduction phaseouts occur at this level of taxable income or adjusted gross income.

The President-elect seems to favor restoring the SALT (state and local taxes) deductions many Americans benefited from when itemizing deductions, albeit when the standard deduction was half where it is now, as a result of The Tax and Jobs Act that limited SALT deductions to $10,000, and limited the deductibility of home mortgage interest on acquisition of a property, which left anyone seeking to improve, renovate or otherwise improve their homestead property with no tax deduction for interest paid on loans for this activity.

The payroll tax provisions should have little impact on small business owners who operate through pass-through entities such as S-Corporations, LLCs taxed as S-Corporations, partnerships, or LLCs taxed as partnerships. Highly compensated owners and partners can easily avoid the expansion of the social security tax by balancing W-2 salary and profit distributions. This provision seems to target highly compensated large corporation employees and executives who receive all their salary and bonus compensation via W-2.

A Biden Tax Plan, as proposed, will bring estate transfer tax planning back into vogue. The exemptions are currently so high that very few American families fall prey to the estate transfer tax. Those that do, usually have the best advice to plan around those issues for their extraordinarily large estates. Many more American families will need to plan for a new estate tax regime should this part of the Biden plan be codified in legislation and become law. It is obvious from the proposed exemption amounts Mr. Biden is attempting to avoid the onerous taxation of small family operated businesses while capturing taxes on larger estate transfers.

The other clear intent found in the Biden plan, and rhetoric throughout the campaign, is the alternative energy initiative. I think we can count on either restoration of prior incentives to move toward alternative energy sources in our homes, cars, and businesses, or new incentive programs beyond what is in place today.

Disclosures

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