

ADVISOR THOUGHTS

DECEMBER 2020

A BIDEN TAX HIKE?

President-Elect Biden has released an income tax plan that seeks to roll back the 2018 Trump tax cuts to the extent they benefited high income taxpayers. Supporters of the Biden plan argue that no one with taxable incomes of less than \$400,000 will see an income tax increase. In looking at the details of the plan, the most significant tax increase would be on those with incomes higher than the \$400,000 as currently being reported.

Biden has indicated that he would like to raise 2021 income taxes for those in the highest tax bracket—single individuals with taxable incomes above \$523,600 and married couples filing jointly with taxable income over \$628,300. Simply put, taxable income is total income less one's itemized or standard deduction—it is important to remember that two clients may have similar incomes, but very different deductions, creating very different taxable incomes. Like most things with the Internal Revenue Code, Biden's proposal is more complicated the more we look at it. One thing is clear, however—his plan would increase federal income taxes for those taxpayers in the highest tax bracket which is 37.0%.

For decades, there has always been separate rates of tax on ordinary income and capital gain income; the ordinary rate is higher than the capital gains rate. Capital gain income consists primarily of two categories of income—long-term capital gains (most typical are sales of stocks held for more than one year) and qualified dividends. Most taxpayers pay between 0% and 15% on capital gains; the highest income taxpayers pay a maximum rate of 20%. (For the purposes of this article, the 3.8% Net Investment Income Tax, which is assessed on most individual taxpayers to the extent their incomes exceed at least \$200,000 (married couples at least \$250,000), and is part of the Affordable Care Act currently under challenge before the US Supreme Court, is disregarded). Ordinary income is everything else including wages, distributions from IRAs, pensions, and other retirement plan distributions, interest, rental income, and taxable Social Security benefits.

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The Biden tax plan would reverse President Trump's tax cuts for higher income taxpayers that began with the 2018 tax year. The top rate of tax for ordinary income was reduced from 39.6% to 37.0%. The Biden plan would reinstate the top rate of 39.6% for only those taxpayers in the 37% ordinary income tax bracket. The other current graduated income tax brackets would remain at the levels introduced in 2018-- 10%, 12%, 22%, 24%, 32% and 35%.

Biden's proposal would include an increase in taxes on long-term capital gains and qualified dividends for taxpayers with incomes over \$1 million. Currently, high-income taxpayers pay a maximum capital gains tax rate of 20%. Biden would eliminate the preference between ordinary and capital gain rates for these taxpayers—they would pay 39.6% on all taxable income.

Two Biden proposals would raise taxes on a portion of taxpayers with taxable incomes of \$400,000 by limiting the amount of itemized deductions these taxpayers can take and the elimination of the 20% Qualified Business Income Deduction. The 'phasing out' of itemized deductions would affect many of our clients at first glance, but the Biden plan would allow taxpayers to claim a full deduction for state and local income and property taxes paid. Current law limits the state and local tax deduction to \$10,000, which has caused many Americans to see a tax increase the last two years. Also, with good planning, taxpayers can control the timing of their deductions to avoid this pitfall.

The 20% Qualified Business Deduction allows non-corporate taxpayers engaged in a qualified business to deduct 20% of their earnings from taxation. While most of our tax clients that we prepare their income tax returns for are retired, the few that are presently engaged in a qualified business can soften the impact of the Biden plan by using lawful efforts to time the payment of expenses and collection of fees.

The last Biden proposal I wish to address is the plan to eliminate the "step-up" in basis on inherited assets. Currently, when one inherits property, the decedent's cost basis in the property is ignored; the beneficiary recipient receives a basis that is stepped-up to the fair market value on the decedent's date of death. So, if the heir sells the property soon after inheriting it, minimal gain or loss results. Considering that the step-up provisions have been such an important part of estate and tax planning for several decades, and the fact that there are a few Senate Democrats who are against the idea, I see no chance the Biden plan relating to the elimination of the step-up becoming law. It is, however, important for our clients to know that the proposal is out there.

The Biden income tax plan is likely to face great difficulty in being passed, even if the Democrats manage to secure a 50-50 split in the Senate by winning the two Georgia Senate races in early January. Some Senate Democrats may not agree to increasing taxes as proposed under the Biden plan, and no Republican Senator has indicated support for the Biden plan.

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Whether or not the Biden plan becomes law, we at Ledyard Financial Advisors will be prepared to offer solid, consistent, and pragmatic tax advice and portfolio management to our clients. Our tax planning includes regular reviews during the year of our clients' capital gains, charitable commitments, and changes in their personal lives that could have a significant impact on their annual tax liability. Our portfolio management team employs long-term strategies that include holding quality, dividend-paying stocks, in part because qualified dividends enjoy the favorable capital gain rate tax treatment. We always look to lower the tax burden of our clients, in a calm and deliberate way, by being aware of both actual and proposed changes to federal and state tax regulation.



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