McSwiney & Wood Law Firm P.C. Winter 2021 Newsletter

Greetings,
Our office hours for this winter are Monday-Friday from 9 am to 5 pm. Due to the Covid-19 pandemic, we are only scheduling in-person appointments for estate planning document signings. All other meetings are via teleconference, Zoom, or FaceTime. You can arrange these appointments by giving us a call at (603) 526-6955 and speaking to Karen Shaughnessy.

Now that the election is over, our Winter newsletter focuses on President Biden's proposed tax plan. With the Democratic Party winning both Senate-runoff elections in Georgia, they now have a 50-50 majority in the Senate, with Vice-President Kamala Harris serving as the tie-breaking vote. Due to these narrow margins, keep in mind that any legislation is only likely to pass with bipartisan support. Here are President Biden's main proposals:

- The top individual federal income tax rate would rise from 37% to the pre-President Trump rate of 39.6% for high-income taxpayers.
- The corporate rate would rise from 21% to 28%; a 15% alternative minimum tax would apply to corporate book income of $100 million and higher.
- Individuals earning $400,000 or more would pay additional payroll taxes.
- The maximum Child and Dependent Tax Credit would rise from $3,000 to $8,000 ($16,000 for more than one dependent).
- Tax relief would be offered for student debt forgiveness and the first-time homebuyer's credit would be restored.
- The estate tax exemption would drop by about 50%.

President Biden's plan would restore higher taxes on corporations and high-income individuals, generally, protects taxpayers with incomes of less than $400,000 from tax rate increases, and provide an array of new and revised personal tax benefits targeted for low- and middle-income families. The Social Security tax would be extended to higher income levels, the estate tax exemption would be reduced by approximately 50%, and the step-up in the basis of death would be repealed. Here are the key elements of his platform on taxes. Note that all these changes would need to be enacted by Congress to become law.

Wealthy Individuals - Restoring Higher Tax Rates and Alternative Minimum Tax:
The President Biden tax plan would repeal the major tax reductions passed in 2017; it would increase the top individual federal income tax rate from 37% to the pre-President Trump rate of 39.6% and the corporate rate from 21% to 28%. For individuals with incomes of $400,000 or more, the tax benefit afforded itemized deductions would be capped at 28%, rather than the higher value of their applicable tax bracket. Tax rates would be graduated so that individual taxpayers with incomes below $400,000 would not see rate increases. The "carried interest" loophole would disappear, and those earning $1 million or more would pay ordinary income tax rates on investment income.

To make the tax treatment of wage-earners and wealthy investors similar, taxpayers whose income exceeds $1 million would pay the same rate on investment income as applies to wages. In addition, the carried interest "loophole," claimed by many private-equity and hedge-fund managers, would be eliminated. These fund managers pay capital gains tax rates—currently levied at 20%—instead of ordinary income rates on their "carried interests," i.e., high, fixed-rate participations in their funds' profits, while making little or no capital investment.

Corporations: The corporate tax rate would increase from 21% to 28%. To prevent profitable companies from paying no tax, all corporations would be subject to a 15% percent alternative minimum tax (AMT) on book income. All foreign income earned by US companies' overseas operations would be taxed at 21%, twice the current rate.

The plan also indicates that President Biden's administration would promote tax provisions to penalize exporting jobs overseas and to incentivize investments in infrastructure and green energy, transportation, and manufacturing. Businesses would be offered a variety of new tax credits, ranging from benefits to deal with workforce layoffs to small business incentives to provide retirement savings plans.

It is difficult to predict or quantify what, if any, impact these tax changes might have on corporate stock valuations—and, thus, on the value of stock portfolios and retirement savings. Any effect on stock values probably would depend on the extent to which individual corporations had benefited from the provisions that President Biden's plan would reduce or eliminate. With respect to the proposed AMT on book income, the key point would be the extent to which the income reported for financial purposes exceeds the income reported on their corporate tax returns.

Benefits for Individuals and Families:
President Biden's tax plan also emphasizes new and revised tax benefits for "working families." A key element of President Biden's policy is the use of tax credits, often refundable, rather than tax deductions, to counter the greater savings that deductions provide to higher-income taxpayers compared to lower-and middle-income individuals.

Retirement Tax Benefits: One significant potential substitution of a tax credit for a present-law deduction applies to retirement savings. President Biden's plan would include rules, details unspecified, to equalize the tax benefits for contributions to 401(k)s and other retirement plans across the income scale.

Depending on the design of the new provision, the impact on high-income taxpayers could be substantial. For example, if the proposed revision of the 401(k)-contribution benefit entitled a taxpayer with a marginal tax rate of 35% to a 20% tax credit instead of the present law's tax deduction, the tax savings for the current, maximum annual contribution of $19,500 would decline from $6,852 to $3,900.

Child and Dependent Care: President Biden's plan would liberalize the Child and Dependent Care Tax Credit for qualified expenses. The credit would increase from a current maximum of $3,000 to $8,000, with a ceiling of $16,000 for multiple dependents. The Child Tax Credit would be made fully refundable and rise from $2,000 to $3,000 for children ages 6 to 17, with a credit of $3,600 allowed for children under age six. Present law threshold and phase-in limitations would be eliminated.

What Is a Tax Credit?
A tax credit is a direct offset to the amount of taxes owed by a taxpayer. It is a dollar-for-dollar reduction in tax liability. Unlike deductions, which reduce income, tax credits provide the same amount of benefit to all taxpayers regardless of tax bracket. Some tax credits are "refundable," and thus particularly benefit taxpayers who owe less in taxes than the credit amount (those taxpayers get a refund of the balance).

A 20% tax credit for an eligible expenditure of $100, will reduce taxes by $20 for every taxpayer regardless of income level or tax bracket. On the other hand, an exclusion, exemption, or deduction reduces income and thus provides a larger benefit to taxpayers in higher tax brackets. Some examples:

- For a taxpayer in the 37% marginal tax bracket, a deduction of $100 will save the taxpayer $37, i.e., 37% of the $100.
- For a taxpayer is in the 24% marginal tax bracket, the savings will be lower, $24, i.e., 24% of $100.

Health Insurance Costs: As part of President Biden's program to increase protections and assistance for health insurance access, his tax plan would provide refundable tax credits for healthcare insurance premiums intended to limit families' spending on insurance premiums to no more than 8.5% of their income. In addition, the plan would increase tax benefits for the purchase of long-term care insurance.

First-Time Homebuyer Credit: Recognizing that homeownership is the foundation of family wealth accumulation, President Biden's plan would reinstate the first-time homebuyer tax credit, originally created to help housing in the Great Recession. This credit would be provided at a maximum of $15,000 for first-time home purchasers—and it would be refundable and advanceable to assist buyers at the time of purchase, instead of making them wait until they file their taxes.

Student Debt Help: President Biden's tax plan would afford some tax relief for the burden of student debt, in addition to adding more generous forgiveness and payment-deferral rules for present student loan programs. Under the present law, the amount of any loan forgiveness granted a borrower generally must be reported as taxable income, thereby imposing a new, similarly challenging economic burden. The tax feature of President Biden's student loan assistance would forgive the balance of a borrower's outstanding student loan debt after 20 years without imposing any tax liability.

Increases in Payroll and Estate Taxes:
Two features of President Biden's tax plan directly target high-income taxpayers. The first provision would increase Social Security taxes, while the second would increase estate taxes.

Payroll Taxes: For 2020, the Social Security payroll tax is 6.2% each for the employee and employer on wages up to the contribution base of $137,700 ($142,800 in 2021). Self-employed individuals are liable for Social Security tax of 12.4% on their net profits. President Biden's plan would impose an additional Social Security payroll tax of 6.2% each on employer and employee on all earned income of $400,000 or more. Under the plan, no additional Social Security tax would be imposed on wages between the wage base, currently $137,700, up to $400,000.

Estate Tax Exemption: President Biden's tax plan entails two changes to the federal estate tax. It would reduce the estate tax exemption by approximately 50 percent from its current level of $11.58 million of estate assets, thereby restoring the threshold for taxable estates to its pre-President Trump level. Tax experts generally believe that most very wealthy individuals already take advantage of sophisticated tax-planning strategies that reduce their estate-tax liabilities and will continue to do so. Therefore, the lower exemption level may result merely in expanded tax planning.

Step-Up in Basis. The second change would repeal the present law "step-up in basis" rule that increases the tax basis for inherited assets to their full fair market value upon death. This rule—which 'carries over' an asset's tax basis from the testator to the heir—likely would entail a significantly greater overall tax burden with respect to transferred assets than would the decreased exemption.

The current rule benefits all heirs, including those receiving modest assets such as decedents' residences or mutual fund shares from estates valued below the estate tax threshold. Under present law, inherited property receives a full fair market value tax basis. As a result, if the property has appreciated in value since its acquisition by the decedent, the inherent increase in the property's value as of its owner's death permanently escapes capital gains tax. If the heir subsequently sells the property, the heir's taxable gain will be limited to the increase in value over the stepped-up tax basis. The repeal of the step-up in basis rule could prove very costly overtime to heirs of appreciated property at all income levels, not just the wealthiest.

Because of the tax-avoidance benefit of the step-up in tax basis in the present law, wealthy owners of valuable, appreciated assets may retain ownership of such assets until they die, when any potential tax on the appreciation will disappear. Thus, wealthy families can pass on significant wealth for generations without incurring any capital gains tax on the increase in value since the original acquisition of the asset.

While the step-up in basis provides important tax benefits to all wealthy families passing down appreciated assets, including artwork, securities, and other property, from one generation to the next, it is an especially valuable tax benefit for families owning assets whose original tax bases have been reduced by depreciation even while the assets' values have increased above their original cost.

For families with extensive, appreciated real estate investments, for example, the step-up in basis upon death creates a significant motive for tax planning. While real estate investors may hold onto properties for generations, they also can diversify their assets during their lifetimes under the present tax code without having to pay tax on the increase in value. To diversity, they can use such tax-avoidance strategies as like-kind exchanges or contributions to partnerships or real estate investment trusts (REITs). These transactions allow tax-free, lifetime transfers but carry over the transferred realty's depreciated tax basis to the real estate, partnership interests, or REIT shares received for the exchanges or contributions. Any unrealized gain in the original property is reflected in the tax basis of the replacement assets.

President Trumps Tax Cut and Jobs Act of 2017:
If passed, President Biden's legislation would replace former President Trump's tax law passed by Congress in 2017.

Income Tax Rates: The 2017 legislation reduced federal income taxes significantly through reductions in top rates for high-income individuals and corporations and liberalized business deductions; it provided only minor changes for low- and middle-income taxpayers.

Tax Bracket Adjustments: The 2017 law also replaced the CPI adjustment for tax brackets and thresholds that was intended to keep taxpayers—whose wage increases often reflect the CPI—from being pushed into higher tax brackets due to inflation over time. Instead of the CPI, the 2017 law adjusts tax brackets according to a measure called the "Chained CPI."[3] Because this index factors in the notion that consumers may substitute cheaper items for more expensive ones (chicken for steak, say) when prices rise, it generally shows inflation as lower than the CPI does.

Using the Chained CPI is expected to slow down the increase in the bracket and threshold amounts and thereby automatically produce increasingly higher tax bills for individuals over time.[4] Although President Biden's plan criticizes this change as a "secret tax hike on middle-class Americans," it does not explain if or how it might alter the adjustment.

What is the 'Chained CPI'?
The Internal Revenue Code annually adjusts many dollar amounts in tax provisions for inflation to reflect changes in the prices paid by consumers for a broad range of goods and services. Provisions subject to the annual adjustment, which is determined by the Bureau of Labor Statistics of the US Department of Labor, include the standard deduction and tax brackets. As noted above (See "Tax Bracket Adjustments"), the 2017 tax law changed the index used for the adjustment for 2018 and future years from the Consumer Price Index for All Urban Consumers (CPI-U) to the Chained Consumer Price Index for All Urban Consumers (C-CPI-U).

The differences in the two CPIs largely stem from different assumptions about consumers' consumption patterns when prices change. Generally, the traditional CPI-U adjustment—usually referred to simply as the CPI—was based on the increases in the prices for the same items of goods and services over time. The C-CPI-U, or C-CPI, assumes that when prices increase consumers substitute less expensive items for the goods and services whose prices have risen. As result, the C-CPI shows inflation increasing more slowly than the CPI. As discussed above, the lower inflation rate from the Chained CPI is expected to result in individuals paying higher taxes than they would with the traditional CPI.

President Biden's Proposed Changes:
President Biden's plan would reverse many of the 2017 changes. As noted above, it bars tax rate increases for incomes below $400,000; instead, it emphasizes providing tax relief for individuals in the lower tax brackets and equalizing tax benefits for all taxpayers.

President Biden would tax investment income of taxpayers whose income exceeds $1 million at ordinary income rates, allow tax credits rather than deductions for certain personal expenditures, impose higher Social Security and estate taxes on high-income and wealthy individuals, repeal the estate tax step-up on a basis, and tax carried interest fund distributions at ordinary income rates.

The Bottom Line: Will the Biden Tax Plan Increase Your Taxes?
Under President Biden's tax plan, the Trump Administration's tax reductions for high-income individuals and corporations would be eliminated while pre-2017 tax rates would be restored, and alternative minimum taxes and taxes on investment income and estates would rise. Overall federal taxes owed by corporations and wealthy and higher-income taxpayers would increase. However, lower-income individuals' rates generally would not change, and families would be entitled to expanded credits and deductions.

Will President Biden increase your taxes? That depends on the amount of income that you have earned. Taxes on individual incomes below $400,000 would not face an increase. New and expanded tax benefits, outlined above, including provisions for childcare, first-time homebuyers, educational debt relief, retirement savings, health insurance, and long-term care could reduce taxes for middle-class families.

President Biden's tax plan would, however, increase taxes for most taxpayers with incomes of $400,000 or more. It would reinstate the pre-2017 top marginal tax rate of 39.6 %, substitute flat-rate tax credits for some deductions, including those contributions to retirement plans. Individuals with incomes of more than $1 million would pay the same rate on investment income as on wages, and equity and hedge fund managers would be subject to ordinary income rates on "carried interests." In addition, the payroll tax for Social Security would apply to earnings of $400,000 or more (but not between the current wage base of $137,700—$142,800 in 20201—up to $400,000). The estate tax exemption would fall back approximately to $5.5 million and step-up in basis at death would be repealed.

I hope you all had a great holiday season. Don't hesitate to reach out to me if you have any questions or would like to schedule a meeting.

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