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WEALTH MATTERS

How the Wealthy Are Trying to Anticipate Biden's Tax Increases

Financial advisers say they have been flooded with calls from clients who are trying to predict which of President Biden's tax proposals will become law.

By Paul Sullivan

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President Biden this week proposed significant increases in taxes on the wealthy. And while the details are likely to change as the legislation makes its way through Congress, wealthy Americans were scrambling to lock in tax savings before they even knew what the proposal was.

The proposed higher taxes on income and capital gains — which would nearly double for the highest earners — were expected. But the American Families Plan, as the White House calls it, was silent on an anticipated increase in estate and gift taxes. Instead, it included a provision requiring heirs to pay capital gains taxes on assets above a certain amount that they inherit.

Advisers to the wealthy say they have been flooded with requests to make plans for what any eventual tax changes will be. And assuming that the president's proposal will not go into law as is, they have been asking their advisers for help in understanding what could be added from the "For the 99.5 percent" plan floated by Senators Bernie Sanders and Elizabeth Warren and others.

"I don't know where we're going with any of these taxes," said Bill Schwartz, managing director of Wealthspire Advisors, which advises clients with $5 million to $20 million in assets. "But I do know it's really difficult right now to justify what people call a loophole or what I call using the tax code to your advantage. In fact, it's really hard to justify any of these techniques for the affluent right now, not that I think they're right or wrong."

Since Mr. Biden won the election in the fall, I have written a couple of columns on the expected tax increases. Here's what we know now, with planning thoughts for each one.

Income tax: The top marginal rate would go up to 39.6 percent, from 37 percent. That is where it was during President Barack Obama's administration.

While marginal rates are calculated on income bands, Mr. Biden's proposal would raise taxes not just on people currently subject to the highest rate of 37 percent. That rate currently starts when someone earns more than $518,000 or a couple earns more than $622,000.

The 39.6 percent rate would start with people earning $400,000 a year, which was where it was during part of the Obama administration. It would affect many people on the high-earning but high-cost coasts who might not consider themselves wealthy.

To avoid the higher tax, people who have the ability to determine when they collect income could accelerate it now when the rate is lower.

This could include collecting a bonus or negotiating a future payment early, said Michael Nathanson, chief executive of the Colony Group. It could also mean converting an individual retirement account to a Roth I.R.A. in order to pay the lower taxes now.

Capital gains: The proposed capital gains increase doubles the rate that high-earners would pay when they sold their investments. But it would also affect people who have one-time, big-dollar events — like selling a family business.

The current rate is 20 percent, and Mr. Biden has proposed increasing it to 39.6 percent. Added on top of both rates is a 3.8 percent surcharge to help pay for the Affordable Care Act.

Wealth planners raised a couple of issues with this proposal. First is how the increase would influence people's behavior. Planners critical of the increase say the lower capital gains tax was meant to give an incentive to save and not spend.

"The capital gains increase is not just for the consistently high, $1 million-a-year earner," said Mallon FitzPatrick, head of financial planning at Robertson Stephens Wealth Management. "It's impacting people who are depending on this money for retirement as well, from selling a business or from selling a home."

The proposal also highlights the need to run the math before making any snap decisions. The decision to sell now or hold on to assets that are going to be taxed more heavily depends on when someone needs the money, said Pam Lucina, chief fiduciary officer and head of the trust and advisory practice at Northern Trust Wealth Management.

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Nope. The so-called economic impact payments are not treated as income. In fact, they're technically an advance on a tax credit, known as the Recovery Rebate Credit. The payments could indirectly affect what you pay in state income taxes in a handful of states, where federal tax is deductible against state taxable income, as our colleague Ann Carrns wrote. Read more.

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"If you need those assets to fund short-term goals — less than 10 years — you're slightly better off selling than holding," she said. "But it's different if you have a concentrated position of stock. What do you assume it is going to grow at? That could be a shorter time horizon."

Ms. Lucina said that comparing the projected growth with the possible increase in the capital gains tax would help people make a decision. "Oftentimes, they end up not selling," she said.

Estate and gift tax: A change that was widely expected but not included in Mr. Biden's proposal was lowering the level of estates and gifts that would be exempt from taxes. Mr. Biden was also expected to increase the tax rate. The current exemption level is as generous as it has ever been, at $11.7 million per person, indexed to inflation, while the 40 percent tax rate for any amount above that is historically low.

While the president's proposal left the estate tax untouched, Ms. Lucina said she had still been getting calls from wealthy clients this week. She said she was telling them to think about their options, but not try to predict, when it comes to estate and gift taxes.

Mr. Biden did, however, propose eliminating a provision that values the assets in someone's estate at whatever they were on the date of death. That provision, known as a step-up in basis, wiped out years of capital gains that were never declared, depriving the Treasury of significant tax revenue.

"It'll raise a fair amount of money," said David Pratt, chairman of the private client services department at the law firm Proskauer. "But it's a double whammy. You still have the estate tax."

The wealthiest will still have to worry about the limit on the estate tax exemption and the tax rate above that. But they will also have to look at whether they can pass along assets whose value is close to their purchase price, and that will probably be difficult. Another option is to put them in vehicles like trusts or retirement accounts, where the unrealized capital gains are less of an issue.

The potential loss of the step-up in basis is likely to be a bigger deal for middle-class Americans. Their estates would be exempt from the estate tax, but their heirs would have to calculate the appreciated gains on the assets they inherited.

Mr. Biden has cleared up some issues for the middle class in his proposal. He has recommended an exemption of $1 million on the capital gains of assets transferred to heirs. He has also left in place the $250,000 exemption on taxable gains in the value of a person's primary residence. (These exemptions would double for a couple.)

But in many cases, this would affect people who would not have had to think about paying any tax at death, whether the estate tax exemption remained the current $11.7 million or dropped to $3.5 million, which had been expected to happen.

"The changes to the step-up in basis — that's the curveball," said Paul Saganey, the founder and president of Integrated Partners, a financial advisory firm. "It's really going to surprise people. People don't know what it is or what it means, so how can they quantify the impact of it?"

Also missing was any mention of reinstating the full deduction for state and local taxes, known as SALT. The cap on these deductions in the 2017 tax law hurt people living in the Northeast and West Coast states, where the property and state taxes are higher.

Mr. Biden has proposed limiting a break on real estate transactions. He would cap at $500,000 the value of 1031(b) exchanges, which have essentially allowed real estate investors to roll gains from the sale of buildings into new buildings without ever paying capital gains taxes on them. Coupled with the step-up in basis at death, which wiped out all the gains in value of the buildings, this was a large tax break for families whose wealth rested on real estate investment and ownership.

What is less known is what, if anything, may be adopted from the "For the 99.5 percent" plan. The plan would close some popular tax-reduction strategies, many of which were targeted during the Obama administration.

Three of the proposals would be relatively easy to enact. One would end short-term trusts that allow people to pass tax-free to their heirs expected appreciation — say from the sale of a private business. Another would limit tax-free gifts that can be given each year to trusts to fund things like life insurance to pay estate taxes. A third would curtail special tax treatment that family partnerships receive, even when they own liquid securities and not an operating business.

"They already have the regulations written for these," Ms. Lucina said. "I don't want to scare anyone that these will be enacted. But some of these could be enacted quickly and looked at as loophole closers."