Kayne Anderson Rudnick
Wealth Advisors

How the Biden Tax Plan Could Affect Your Personal Finances

When it comes to your finances, it's not only about how much one makes in appreciation and income, but also how much one keeps after taxes. At Kayne Anderson Rudnick, our goal is to recognize and proactively address potential tax implications on your wealth. With a new tax law on the horizon, we are looking to understand how these changes will impact you and your financial goals and strategies. Now more than ever, it is important for high-net-worth taxpayers to consider and create a plan with their financial and tax advisors, should Congress pass Biden's tax bill.

BIDEN ADMINISTRATION TAX PROPOSALS

Only four full months into the Biden presidency, the first steps towards a formal tax reform plan were announced. On April 28, 2021, the President introduced the American Families Plan, which proposes various tax law changes for the coming year. Other prominent Democrats also have proposed bills that would make significant changes to estates and inherited properties laws, such as the 99.5% Act and the STEP Act.

Most of the tax proposals in the American Families Plan, 99.5% Act and STEP Act target the highest earners to increase federal revenue. This is a result of the tremendous spending in the wake of the coronavirus pandemic in the form of stimulus packages and vaccine rollouts. During the President's early months in office, we have seen a $1.9 trillion COVID relief package, an announcement of a $2.3 trillion infrastructure package and the newly announced $1.8 trillion American Families Plan[1]. That is in addition to the Trump stimulus packages passed in 2020. To add perspective, the IRS collected $3.5 trillion in tax revenue in 2019[1]. Of that amount, 55% was from individual income tax.

WHAT ARE THE PROPOSED CHANGES AND WHO DO THEY AFFECT?

The tables on the following page help summarize some of the relevant changes discussed in the American Families Plan and what income brackets they affect. The President has stated that anyone making less than $400,000 per year will not see a tax increase; however, annual income may not be the only qualification for tax increases. Following the tables, we have described some of the various tax proposals.

1 Data as of May 11, 2021. SOI Tax Stats – IRS Data Book https://www.irs.gov/statistics/soi-tax-stats-irs-data-book#:~:text=During%20Fiscal%20Year%20(FY)%202019,%24452%20billion%20in%20tax%20refunds

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CURRENT FEDERAL TAX RATES

Income/Gain Amount (Assuming Single Filer)	Ordinary Income	Capital Gains	Net Investment Income Tax	Itemized Deductions	Qualified Business Income (QBI) Deduction	1031 Exchanges
$0 – $399,000	10%-35% Marginal Rate	0%-20%	Applies to Passive Income Only*	No Total Cap to Adjusted Gross Income (AGI)	Up to 20% of QBI	Full Deferral
$400,000 – $999,999	35%-37% Marginal Rate	20%	Applies to Passive Income Only	No Total Cap to AGI	Up to 20% of QBI	Full Deferral
$1,000,000+	37% Marginal Rate	20%	Applies to Passive Income Only	No Total Cap to AGI	Up to 20% of QBI	Full Deferral

Data as of December 18, 2017. Data is obtained from the preliminary Details and Analysis of the Tax Cuts and Jobs Act https://taxfoundation.org/final-tax-cuts-and-jobs-act-details-analysis.

PROPOSED FEDERAL TAX RATES

Income/Gain Amount (Assuming Single Filer)	Ordinary Income	Capital Gains	Net Investment Income Tax	Itemized Deductions†	Qualified Business Income (QBI) Deduction	1031 Exchanges
$0 – $399,000	No Change	No Change	No Change*	Uncertain	No Change	No Change
$400,000 – $999,999	39.6% Marginal Rate	No Change	Applies to Active Business Income‡	28% Cap	No Change	Limits Deferring Gains above $500,000
$1,000,000+	39.6% Marginal Rate	Gains Taxed as Ordinary Income	Applies to Active Business Income‡	28% Cap	No Change	Limits Deferring Gains above $500,000

Data as of May 6, 2021. Data is obtained from Details and Analysis of Tax Proposals in President Biden's American Families Plan https://taxfoundation.org/american-families-plan.

BIDEN TAX PLAN KEY TAKEAWAYS

- **Ordinary Income Rates:** The President has stated individuals making under $400,000 per year will not be subject to increased taxes, however this may be dependent on filing status. Two married individuals making slightly over $250,000 per year may become subject to a higher tax bracket, which may have some individuals considering if it is more advantageous to file separately. The proposed Biden plan would change the top marginal tax rate from 37% to 39.6% for individuals making $452,700 and $509,300 for those that are married filing jointly[2].

- **Capital Gains Rates:** The Biden administration has suggested increasing the long-term capital gains rate and qualified dividends to ordinary income rates for earners making more than $1,000,000 per year. It is not clear yet if the law is intended to tax every dollar over $1,000,000 at ordinary income tax rates or if all capital gains and qualified dividends will be taxed at ordinary income tax rates if the $1,000,000 threshold is met.

- **Expansion of the Net Investment Income Tax:** The new tax law proposes to expand the income subject to the 3.8% tax from passive income to "active income earned in businesses" above $400,000. Currently, active business income is excluded from the 3.8% net investment income tax. This would subject any operating business income where the member actively participates and active real estate investors who make over $400,000 in their real estate activities to be subject to an additional 3.8%.

- **Itemized Deductions:** The President's plan brings back the Pease Limitation to itemized deductions. This means for individuals meeting a certain threshold of income (in 2017, prior to its repeal by the Tax Cuts and Jobs Act [TCJA], it was $261,500), 3% of certain itemized deductions are added back. Additionally, when Biden was running for President, his campaign stated a 28% adjusted gross income (AGI) limitation on total itemized deductions. The American Families Plan did not add details behind this, so we will have to wait and see if it comes to fruition. One

** Applies to Passive Income over $200,000 for an individual filer.*
† Itemized deductions were not included in the American Families Plan; however, the 28% cap was part of the tax policy from Biden's campaign.
‡ Applies to Active Business income over $400,000 for an individual filer.
2 https://taxfoundation.org/american-families-plan

positive benefit for high earners will be if the State and Local Income Tax Deduction (SALT) is brought back. Democrats have been fighting to restore this deduction for the past couple of years but have not been successful. This was one of the largest itemized deductions for high earners in high income tax states, such as California and New York. However, even if SALT deductions are restored, taxpayers subject to the Alternative Minimum Tax (AMT) will continue to lose the benefit of their state and local tax deduction because the SALT deduction is disallowed from AMT calculations.

- **Qualified Business Income Deduction:** Prior to the announcement of the American Families Plan, the Biden administration was looking to phase out the Qualified Business Income Deduction for incomes over $400,000. However, The American Families Plan made no mention of any adjustments to this deduction.

- **Limitation on 1031 Exchanges:** The American Families Plan will limit the gain on 1031 Exchanges up to $500,000. Any additional amounts over the $500,000 would be subject to capital gains rates. This $500,000 would also contribute towards the $1,000,000 ordinary income limitation, so if an individual had another $500,000 from other income sources in that tax year, a portion of the gain may be subject to ordinary income tax rates.

- **IRA Contribution Deduction:** The President's plan has proposed turning the current dollar-for-dollar reduction of AGI for IRA contributions into an IRA credit. For higher earners, every additional dollar is taxed at a higher rate, so an individual currently in the 37% bracket would get a $3,700 benefit for every $10,000 contributed. If the deduction becomes a flat 26% credit, then earners in tax brackets higher than 26% would lose some of their current deduction benefit.

  Roth IRAs may be more beneficial for certain individuals if the IRA deduction is turned into an IRA credit. The SECURE Act also made Roth Conversions more attractive since there are no adverse tax consequences from the new 10-year distribution rule for inherited IRAs.

ESTATE AND GIFT TAX

- **Lifetime and Annual Gift Exclusion:** There are current bills that have been proposed in the House and the Senate that significantly increase tax transfers and gifts of wealth.

- **Step-Up in Basis at Death:** The American Families Plan mentions changes to the step-up in basis at death rule. Unrealized gains will be treated as sold with an exemption of $1 million per person. This will be in addition to the $250,000 primary home exclusion per individual. This could trigger serious tax implications for individuals who are passing significantly appreciated assets to children. It will be important to understand what assets are being passed down and what the tax impact will be. Charitable donations using charitable trusts with low basis assets may be a potential solution to the tax implications of passing the assets to their children.

- **The STEP Act:** Similar to the changes introduced in the American Families Plan, the STEP Act looks to limit the step-up in basis on assets at the time of a gift or death. Currently, when an individual dies, the beneficiary of the assets receives a step-up in basis to the fair market value of the asset at the time of death. If the asset was immediately sold after the death of an individual there would be, in theory, no capital gains tax because the basis is equal to fair market value.

- **The 99.5% Act:** Introduced by Senator Bernie Sanders, the 99.5% Act reduces the federal estate and gift tax credits by dramatically increasing tax rates on any assets gifted or inherited over $3,500,000, as shown in the table below.

Taxable Estate Value	Proposed Marginal Estate Tax Rate	Increase from Current 40% Rate
$3.5 million to less than $10 million	45%	12.5%
$10 million to less than $50 million	50%	25%
$50 million to less than $1 billion	55%	37.5%
$1 billion or more	65%	62.5%

Data as of March 25, 2021. Data is obtained from Senator Sanders, Rep. Gomez Unveil "For the 99.5% Act" Reforming Estate Tax https://americansfortaxfairness.org/issue/senator-sanders-rep-gomez-unveil-99-5-act-reforming-estate-tax.

For example, if an individual has a $45,000,000 dollar estate at their death and the asset were passing to a non-spouse, their estate would be subject to an estate tax liability of $22,000,000. That is a 45% tax on the first $10,000,000, which equals $4,500,000 and a 50% tax on the remaining $35,000,000, which equals $17,500,000.

Grantor Trusts would also be included in the estate of an individual at their death. Closely held Family Limited Partnerships (FLPs) will not receive valuation discounts for lack of marketability and lack of control to the extent they are comprised of passive investments, such as securities or non-actively managed real estate. Currently, the lifetime exclusion amount is $11,700,000 for an individual and sunsets in 2026 to $5,000,000 adjusted for inflation. This bill also looks to include Grantor Trusts in the estate of an individual for estate tax purposes. This means any prior planning done with Grantor Trusts would need to be reviewed to understand any estate tax implications.

Other important considerations:

- Lump-sum payouts will become increasingly important to plan for to make sure the proposed income thresholds, which would subject income to higher marginal income tax rates in that year, are not exceeded. Those events could include:
  - Business sales
  - Stock and stock option sales and realization
  - Real estate sales
  - Gambling/lottery winnings
- Qualified charitable distributions will continue to be useful in order to lower AGI for individuals who are not dependent on their required minimum distributions.
- Individuals in high tax states may get an increase in their itemized deductions if the current $10,000 state and local tax limitation is changed. However, a potential cap on itemized deductions as well as the adjustment for the AMT, may limit or completely disallow this deduction for some taxpayers.

WHEN WILL THE PROPOSED TAX CHANGES BE IMPLEMENTED?

With their slim majority in the Senate and 219 seats in the House (a simple majority is 218), Democrats may need to concede some of their more aggressive provisions in the plan in order to push the bill through by the end of the year. While we cannot confirm the certainty of its passage, the tax law appears to be a high priority for the President and his party.

IS THERE A POTENTIAL FOR RETROACTIVE TAX?

While relatively unprecedented, there is the possibility that any tax laws passed will have the potential to be retroactive back to tax year 2021. It would be more likely that only certain provisions of the complete tax law are retroactive, however it is unclear as to which ones those may be. The Tax Reform Act of 1969 had over 40 enactment dates of which 20 were retroactive[3]. Different bills proposed in the Senate and House also may have different effective dates as well, so it will be important to understand the effective date of the provisions as the bills are refined and a singular bill is voted on. It was also recently reported by *The Wall Street Journal*[4] that the President's budget assumes that the capital gains increase to ordinary income tax rates is effective as of April 28 (when the American Families Plan was announced). This could potentially signify the intention to make some provisions of the law retroactive.

Navigating tax laws can be complicated and we understand the need to stay ahead of any possible changes. The final outcome of the proposed changes may be different than what is known today, and we encourage clients to begin having discussions with their tax and legal advisors as well as connect with your Kayne Anderson Rudnick advisor. It is always a pleasure to connect with our clients, and we look forward to addressing your questions and concerns.

3 https://www.washingtonpost.com/outlook/2021/04/12/tax-increase-retroactive-biden/
4 https://www.wsj.com/articles/biden-budget-said-to-assume-capital-gains-tax-rate-increase-started-in-late-april-11622127432?mod=hp_lead_pos2

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