Wealth Management

The Crescent Group

RBC Wealth Management

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April 2021 Crescent Commentary

Last month, the Biden administration announced a slate of proposed tax increases designed to pay for $6 trillion in new federal spending over the next decade. In this commentary, we will review how these proposed changes could potentially impact your wealth. It's important to start out this discussion by acknowledging that any and all numbers and legislative changes are completely preliminary. Even if some or all of these proposals become law – itself uncertain – the numbers will also likely go through an intense negotiation process and could end up quite different from the proposals[1][2].

As it stands now, the key Biden tax increases consist of:

(1) Taxing long-term capital gains as ordinary income for households earning $1 million or more annually
(2) Eliminating the tax basis step-up at death for inherited capital gains in excess of $1 million for individuals / $2 million for couples
(3) Increasing the income tax rate to 39.6% for households earning the top 1% of income
(4) Eliminating 1031 exchange tax deferral for real estate investment gains greater than $500,000
(5) Standardizing a 3.8% Medicare tax on all individuals earning $400,000 or more annually

For capital gains, most people currently pay a 15% capital gains tax when they sell investments they've held for a year or more (gains on investments held for less than a year are taxed at your ordinary income tax rate). Households earning the top 1% of income currently pay 20%. The Biden proposal would increase the capital gains tax rate from 20% to 39.6% for households earning $1 million or more of annual income.

Currently, one potential way for an investor to avoid paying capital gains taxes would be to pass their assets to their heir(s) without selling them. Current tax law only requires heirs to pay the capital gains taxes when they sell the assets they inherited. And the tax only applies to any gains they've made after inheriting the assets. This is referred to as a "step up" in tax basis – the heir's tax basis becomes the investment's price on the day they inherit the asset, not the price at

which the decedent bought the asset. The Biden proposal would eliminate this "step up" in tax basis for heirs who inherit assets with an embedded gain of $1 million or more. This means if you leave assets with an embedded unrealized gain of $1 million or more to your heirs, the heirs will have to pay taxes on any gains in excess of $1 million upon inheritance.

The increased income tax rate for households earning the top 1% of income is fairly self-explanatory. The 2017 tax law reduced the top rate to 37%, and the Biden proposal returns it to 39.6%.

1031 exchanges have allowed real estate investors to defer taxes on gains when they sell one qualifying property and move the proceeds to another qualifying property. The Biden administration proposes to eliminate this tax deferral for gains greater than $500,000.

Finally, high income individuals have generally paid a 3.8% Medicare tax on their earnings. Due to loopholes, the tax has not applied uniformly across individuals. Biden proposes to apply the tax across all individuals earning more than $400,000 annually.

After we have concrete information on what changes in tax law will actually take place and what the final numbers are, our Group will work closely with impacted clients to optimize your financial plan in light of the tax law changes.

As we mentioned at the beginning of this commentary, these proposals remain highly preliminary, and it's uncertain which proposed changes Congress will or won't pass. Furthermore, those proposals which are passed will go through an intense process of negotiation and the exact numbers will likely change. But there's one overriding trend that investors must pay careful attention to: the trend in the United States over the past hundred years has been increasing federal government spending. From the New Deal almost a hundred years ago (including Social Security in 1935), Medicare in 1965, to myriad other programs along the way. More recently, the federal government spent around $1.8 trillion of stimulus in 2008 to pull the U.S. out of the financial crisis. That seemed like a lot of money, and it was. But the covid-19 stimulus legislation proposals aggregate to $3.5 trillion. And as we mentioned in our introduction, more spending is planned. Considering these long-term spending patterns, we think future tax rates will remain flat at best. Can we be wrong about that? Absolutely. But when we're designing a financial bridge to support a client for the rest of their life, we don't cut it close. If your bridge needs to support $5 million in spending over your retirement, you don't design it to support $5 million, you design it to support $6 million. Our expectation for tax rates that remain flat at best means investors must own assets with long-term returns that can overcome the wealth impact of higher tax rates. We will continue to work closely with our clients to make sure we optimize your best return for the least amount of risk, in order to overcome the hurdle of potentially higher taxes, as well as other hurdles likely to surface in the future[3][4].

Best regards,

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Sources:

(1) Whitehouse.gov
(2) The Wall Street Journal
(3) The United States Treasury
(4) Committee for a Responsible Federal Budget

The views presented herein are solely those of **The Crescent Group**, and do not necessarily represent the views of RBC Wealth Management. Current status of issues discussed in this letter is subject to change based upon market conditions and industry fundamentals. Clients should work with their Financial Advisor to develop investment strategies tailored to their own financial circumstances. Past performance is no guarantee of future results.

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