TAX UPDATE 2021: Capital Gains Take Center Stage

By Kristi Mathisen

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As expected, President Biden has proposed a federal budget that includes higher taxes on the wealthy. Somewhat surprisingly, the focus has shifted from what was front-and-center during the Presidential campaign — an annual wealth tax and/or higher estate taxes. Instead, the Biden budget shines a spotlight on part of the US tax code that has not gotten much attention in decades: long-term capital gains (on assets held longer than 12 months).

The reasons: to raise a lot of revenue quickly; and to reduce inequality in how ordinary income is taxed vs. income from investments, including corporate dividends. As the chart below shows, the most anyone now pays in taxes on long-term capital gains and qualified dividends is 20% (plus the 3.8% surtax on investment income). A married couple reporting roughly $500,000 this year — all from capital gains – will pay 15% in income taxes vs. 35% if this were taxed as regular income.

US Tax Rates on Long-Term Capital Gains* (2021)

Single		Married, Filing Jointly	
Taxable Income	**Gains Tax Rate**	**Taxable Income**	**Gains Tax Rate**
$0 to $40,400	0%	$0 to $80,800	0%
$40,401 to $445,800	15%	$80,801 to $501,600	15%
Over $445,801	20%	Over $501,601	20%

*People with income over $200,000 (unmarried) or $250,000 (married filing jointly) also pay a 3.8% surtax on net investment income.

In addition, capital gains taxes can be put off indefinitely since they are paid only when an asset is sold. Upon death, capital gains get zeroed out due to what is known as "stepped up basis." If heirs sell immediately, they can avoid capital gains taxes altogether. All this has made "buy-and-hold" an attractive strategy, especially when cash needs can be met by borrowing at currently low interest rates.

The Biden proposals would chip away at the tax-advantaged status of capital gains, especially for higher-income households. The proposed changes, echoed in a bill proposed by Democrats in the US Senate, are major and historic:

Changes to the capital gains rate. Only for households with adjusted gross income (AGI) over $1 million: long-term capital gains and qualified dividends would be taxed at the tax filer's highest marginal income tax rate, currently 37%. Note that AGI is income before tax deductions, so it is higher than taxable income. And somewhat controversially, this change would apply retroactively, possibly as early as April 28, 2021 when the Biden proposal was formally announced.

What this means: A nearly 100% increase in the capital gains rate for upper-income households. Meanwhile, those with less than $1 million in adjustable gross income would continue to benefit from the lower capital gains rates: 0%, 15% and 20%.

When capital gains are recognized and taxed. Under the Biden proposal, capital gains would be taxed anytime assets change ownership, not just when they're sold. This change, which would apply starting in 2022, would be the most significant departure from past policy. And it applies to households at all income levels, although there is a $1 million lifetime exclusion ($2 million for married couples).

- **Lifetime transfers.** Capital gains would be recognized when you give assets away to a person (spouses excluded), a trust, or business entity, such as an LLC or partnership (nonprofits excluded). Partial transfers of ownership would be taxed proportionately. If the transfer is to/from a trust that you totally control and whose taxes you pay (a revocable grantor trust), no capital gains would be recognized.
- **Capital gains taxes on estates.** Upon death, there would be no "stepped up" basis on the valuation of assets. Taxes would be due on any accumulated capital gains (minus any losses) and reported on the decedent's final income tax return. For estate tax purposes, capital gains taxes paid would be deducted from the value of the estate.

CAPITAL GAINS EXEMPTIONS

The Biden tax proposal on capital gains would NOT apply to:

- Up to $1 million in unrecognized capital gains per lifetime ($2 million for married coupled), indexed for inflation
- Most family-owned and operated businesses until they are sold or no longer managed by the family
- Certain small business stock
- Gains on a primary residence up to $250,000 for a single person, $500,000 for a married couple.
- Household furnishings and personal effects – but not collectibles.
- Taxes on illiquid assets (not publicly traded, etc.) held at death could be paid over 15 years.

Also worth noting: There would be a maximum period – 90 years – that a trust, LLC, partnership or other non-corporate entity can put off recognizing capital gains and paying the related tax. That period would start Jan. 1, 1940, so the first possbile recognition event would be Dec. 31, 2030.

CAPITAL GAINS IN BIDEN ERA: WHAT COULD CHANGE

	Under $501,600 Taxable Income^	**Over $501,600 Taxable Income^**	**Over $1 million Adjusted Gross Income# (AGI)**
Long-term capital gains rate	**No change: 0% - 20%**	**No change: 0% - 20%**	**37%** (proposed increase to 39.6%)
Capital gains taxes due on asset transfers as well as sales*	**Yes**	**Yes**	**Yes**

^Married couple filing jointly. #Annual adjusted gross income (AGI) for both married filing jointly and single filers.
*$1 million lifetime exemption ($2 million for married filing jointly).

OTHER TAX PROPOSALS IN BIDEN BUDGET

- Top income tax rate goes back to 39.6% (from 37% currently) effective Jan. 1, 2022; this would also increase the highest capital gains rate

	Current Highest Rates (2021)		Proposed as of Jan. 1, 2022	
	35%	37%	35%	39.6%
Singles*	$209,425 to $523,600	Over $523,600	$209,425 to $452,780	Over $452,780
Married Filing Jointly*	$428,850 to $628,600	Over $628,600	$428,850 to $509,300	Over $509,300

*Income levels to be adjusted for inflation

- Tax-free real estate exchanges (Section 1031) would be limited to $500,000 in gains ($1 million for married filing jointly)
- Carried interest in certain businesses would be treated as regular income if the owner's taxable income is over $400,000
- Business owners would owe the 3.8% Medicare tax even if they forego compensation
- More than $70 billion in extra funding for the IRS plus additional reporting requirements for financial accounts and cryptocurrency

Legislative Outlook

In addition to the tax proposals in the Biden budget, there are two major tax bills before the US Senate:

- *The Sensible Taxation and Equity Promotion Act (STEP)* — focuses on long-term capital gains and is very similar to what the Biden administration is proposing, although a bit more stringent. It is backed by five prominent Democratic Senators: Van Hollen, Booker, Sanders, Whitehouse, Warren.
- *For the 99.5 Percent Act* — focuses on estate taxes. Backed by Senators Sanders and Warren, it would lower the estate and gift tax exemption to $3.5 million vs. $11.7 million currently; raise the highest federal estate rate to 65% (from 40% currently); and limit the discounting of business asset valuations.

Capital gains tax changes: Congress could approve some sort of change to capital gains taxes sometime this year. A key issue is whether the change would apply retroactively to April 2021. Historically, major changes to US tax policy have not been retroactive. And if retroactive, taking action now is not likely to be beneficial.

Estate tax changes: We think higher estate taxes are likely but not this year, since the focus now seems to be on capital gains. The current estate tax exemption expires at the end of 2025, and we could see some aspects of the "For the 99.5 Percent Act" passed before that, if Democrats hold on to Congress.

FOR THE 99.5 PERCENT ACT: KEY PROVISIONS

	99.5 Percent Act	Current Law
Estate Tax Exclusion	**Up to $3.5 million** (up to $1 million in tax-free lifetime gifts)	**Up to $11.7 million** (up to $11.7 million in tax-free lifetime gifts)
Tax Rate	40% on estates $3.5 - $10 million; rises to 65% on over $1 billion	Effective 40% flat rate

WASHIGTON STATE TAX ON CAPITAL GAINS

In May 2021, Governor Inslee signed into law the first-ever state capital gains tax in the United States, although it is being contested in WA state courts. This is a flat 7% tax on long-term capital gains, with a $250,000 annual exemption for both singles and couples filing jointly.

WHEN: Starting January 1, 2022, with taxes due April 15, 2023.

ON WHOM: People whose primary residence is in Washington State AND anyone who has gained from the sale of tangible property located in Washington (excluding real estate).

MAJOR EXCLUSIONS: Real estate, including distributions from privately held entities if the gain is from directly owned real estate; family owned small businesses with less than $10 million in annual revenue; business assets that can be depreciated or expensed.

What to Do Now

If you had already been planning to sell, transfer or gift an asset in the coming year, doing so sooner rather than later makes sense. Now is also a good time to review with us strategies for taking advantage of the higher federal estate tax exclusion.

But we would not take action now solely to avoid a ***potential*** tax rate increase. What is enacted could be very different from what is now ***proposed***, given a divided Congress. The more prudent course is to assess your long-term capital gains exposure and strategies for future transfers and sales, both of which we can help you do. That way, you can be prepared to act when there is more certainty about the legislative outlook.

ABOUT THE AUTHOR

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