A Closer Look

The Changing Tax Landscape

Patrick S. Boyle
Senior Investment Strategist

Calvin C. Huang
Senior Investment Strategist

James L. Kronenberg
Chief Fiduciary Counsel and Head of Wealth Planning

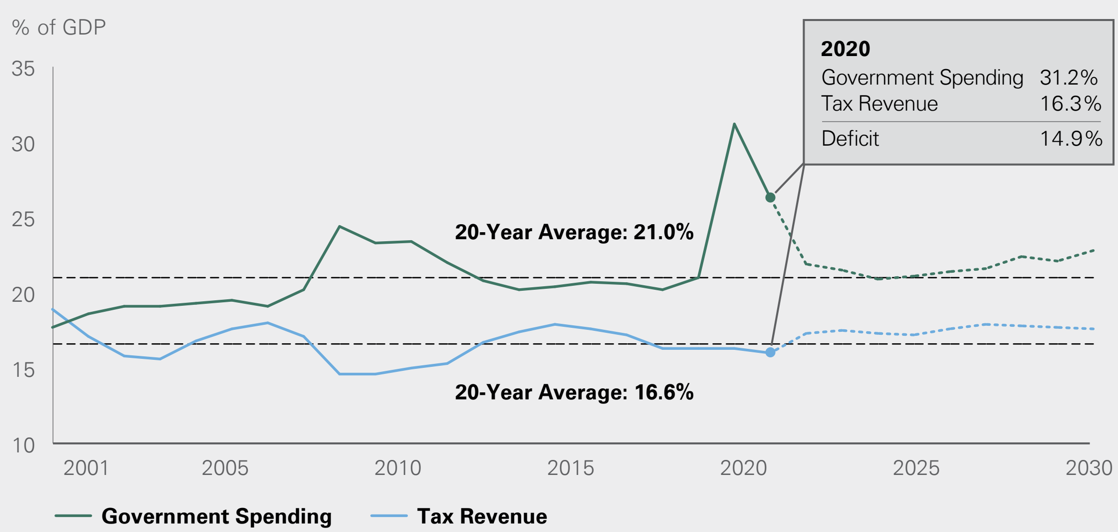
In Brief

- **Tax rates appear likely to move higher in the near term. A few of the proposed tax changes would be material if enacted, including increasing the top long-term capital gains tax rate and eliminating basis step-up upon gift or death.**
- **That said, the tax changes ultimately passed may well be more moderate than many are currently anticipating, and even passage as proposed would not likely be enough to dramatically slow the economy.**
- **In this A Closer Look, we examine the potential investment and planning implications of the various proposals, but it is too early to tell what changes will actually be enacted.**

Tax policy is likely changing soon, and tax rates appear poised to move higher. The current budget deficit (see Exhibit 1) is 15% of GDP as the federal government has spent approximately $5 trillion of borrowed money helping the economy recover from COVID-19. Looking forward, there are plans (American Jobs Plan and American Families Plan) for an additional $4 trillion of spending partially funded by $3 trillion in tax increases. Also, healthcare spending is poised to move higher over time and drive higher overall government spending as Americans age.

Exhibit 1: Revenue and Spending Mismatch Leads to Higher Tax Rates

Key Takeaway: The current budget deficit is 15% of GDP, reflecting significant COVID-19-related government spending; looking forward, deficits are the norm.



Source: Congressional Budget Office

Highlights of President Biden's Tax Plan

President Biden has been clear and consistent that he wants higher tax rates on high-income taxpayers and that he doesn't want tax increases for families with incomes below $400,000 (see our recent Wealth Planning Insights, "Planning for 2021: Biden Individual Income Tax Proposals").

Key provisions of his plan include the following:

- Increasing the top ordinary rate from 37% to 39.6%.
- Increasing the top long-term capital gains and dividend rate from 20% to 39.6% for those with incomes above $1 million.[1]
- Eliminating step-up in basis/instituting a deemed recognition of gain upon a gift or at death, albeit with $1 million exemption.
- Increasing the corporate tax rate from 21% to 28%.[2]

Although predicting exactly how tax policy may change is impossible, we believe tax rates are likely to move higher in the near term.

A Few of the Proposed Changes Would Be Significant if Enacted

Raising the effective top long-term capital gains rate to 43.4% (39.6% plus 3.8%)[3] would be a big change. Historically, the highest effective long-term capital gains rate has been 39.9% (see Exhibit 2), which was seen in the mid- to late 1970s. And eliminating the step-up in basis and forcing a deemed sale of low-basis assets when gifted or at death changes planning significantly and also has important investment implications we will explore.

Actual Changes May Be More Modest

Democrats are "in control" of the federal government, but their margins are narrow in the House and Senate. They can change tax policy without any Republican support through reconciliation,[4] but if they go this direction they can't lose a single Democratic vote in the Senate. And Democrats aren't perfectly aligned on tax policy. As quoted in the April 28, 2021, Wall Street Journal, Bob Menendez, Democratic senator from New Jersey, said, "Right now it [39.6%] seems like a rather high rate to me." Because of the very narrow margins for the Democrats, and the differing opinions within the Democratic party, we expect that actual tax changes may be more modest than what is currently being proposed. For example, the Democrats may end up agreeing to a top long-term capital gains rate of 28%, higher than the current rate of 20%, but short of 39.6%.

What Impact Would Changing the Top Long-Term Capital Gains Tax Rate Have on the Economy and Financial Markets?

GDP has been higher for three quarters in a row and was up 6.4% in the first quarter of 2021. The Fed expects 6.5% real growth for 2021, supported by progress against COVID-19 and a reopening economy. Monetary policy remains supportive as interest rates have moved up but are still low versus history, helping the consumer and housing market. The labor market is eight million jobs short of its February 2020 peak (see our May 7 Investment Insights, "Labor Market Recovery"), but it is recovering, and fiscal policy has helped cushion the blow. Over all, we believe the economy is on stable footing.

President Biden's proposed tax increases ($3 trillion) are being paired with fiscal spending of $4 trillion, so in aggregate, this is a net fiscal expansion over time. But there could be a fiscal drag early on if tax rates increase immediately and more of the spending is spread out over time.

[1] A taxpayer would continue to pay an additional 3.8% net investment income tax as well as any state and/or local taxes that may apply. This would bring the top long-term capital gains rate above 50% for many who are also subject to state income tax.

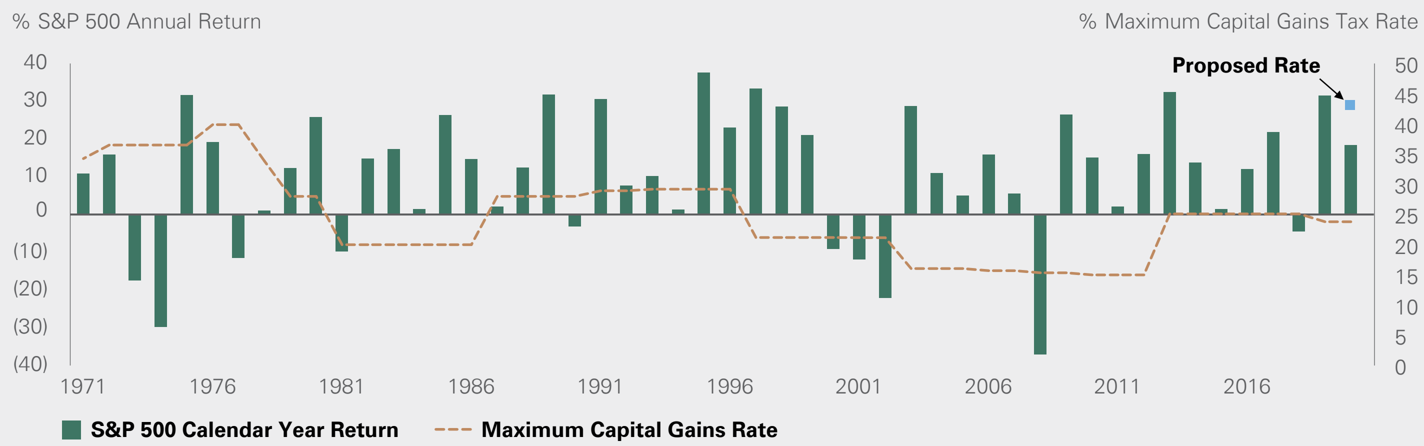
[2] To keep this note brief and more readable, we are not tackling the potential for changing corporate tax rates in detail in this A Closer Look. We may revisit the topic in a future note.

[3] If the top capital gains tax rate is raised to 39.6%, the effective federal maximum rate would become 43.4% after including the 3.8% net investment income tax.

[4] The Democrats may try to use an amended reconciliation bill to pass fiscal legislation along party lines this fiscal year, or they may wait until the beginning of the next fiscal year, October 1, 2021, and start fresh with reconciliation. Or they may choose to pursue a bipartisan approach for all or part of their plan, avoiding reconciliation and giving themselves fewer procedural constraints, but importantly requiring 60 votes in the Senate.

Exhibit 2: No Link With Capital Gains Tax Rate and S&P 500

Key Takeaway: Historically, there has been no relationship between the top long-term capital gains tax rate and the S&P 500.



Source: Factset, U.S. Treasury

In the last 20 years, the correlation between the S&P 500 and the top long-term capital gains rate has been .01, signifying that there hasn't been a relationship between the long-term capital gains rate and the stock market (see Exhibit 2).

There are many reasons for this. Taxes are important, but other things are more important (earnings, interest rates, Fed policy). And roughly 75% of assets are held by investors who aren't sensitive to rising U.S. capital gains tax rates — these include IRA holders, pension plans, foreign investors, etc. And remember President Biden's plan for long-term capital gains would only apply to taxable investors with incomes above $1 million in a given year.[5]

There is always the possibility in the short run that the financial markets don't react well to changing tax policy. Looking back to the late 1960s and mid-1970s in Exhibit 3, the market was lower six and 12 months after the tax changes. But those were also very different economic environments. The equity decline following the 1969 tax increase coincided with the recession of 1970, a year filled with unique external events that impacted the markets, including President Nixon's incursion into Cambodia during the Vietnam War. When the capital gains tax rate was increased again in 1976, the U.S. was in the midst of the worst period of stagflation in American history. Inflation and unemployment both reached the high single digits, and the country was still battling the after effects and higher oil prices following the oil crisis in 1973–74.

As we mentioned earlier, we believe today's economic environment looks much more constructive. Rising capital gains tax rates are one of many things that may impact the economy and stock market, but over all, we don't believe rising capital gains tax rates (and the other proposed tax changes) would be enough to dramatically slow the economy or end the bull market at this point.

Should You Sell Lower-Basis Assets Now to Get Ahead of the Potential Capital Gains Tax Increase?

Normal, good advice when it comes to paying taxes is to defer paying taxes as long as possible. We believe that is still likely to be the right advice in most cases.

The bar for paying taxes sooner than you need to should be set high. We do expect the highest capital gains rate to move up, but it may not move up as much as expected.

[5] Less than 1% of the population would be subject to the highest capital gains tax, but that 1% of income accounts for nearly 75% of all capital gains according to Empirical Research Partners.

Exhibit 3: Tax Policy Is Important, but Economic Conditions Matter More

Key Takeaway: Tax increases have sometimes coincided with short-term market drops in the past, but the primary driver has been economic conditions; today's environment is more constructive.

S&P 500 Index Performance After Increases in Capital Gains Tax Rates[A]

Date of Higher Capital Gains	Old Rate	New Rate	Three Months Before	Next Three Months	Next Six Months	Next 12 Months
1/1/2013	15.0%	23.8%	1.5%	6.7%	10.5%	25.3%
1/1/1987	20.0%	28.0%	5.4%	19.1%	24.0%	0.3%
10/4/1976	36.5%	39.9%	0.5%	1.6%	(5.6%)	(7.7%)
12/30/1969	27.5%	36.5%	(1.6%)	(1.7%)	(20.4%)	(0.6%)
Average			1.4%	6.4%	2.1%	4.3%
Median			1.0%	4.1%	2.4%	(0.2%)

Macro Environment[B]

Date of Higher Capital Gains	GDP Growth YOY	Effective Fed Funds Rate	Unemployment Rate	Core PCE Inflation YOY
1/1/2013	1.6%	0.1%	8.0%	1.6%
1/1/1987	2.7%	6.4%	6.6%	2.5%
10/4/1976	4.3%	5.0%	7.7%	6.4%
12/30/1969	2.0%	9.0%	3.5%	4.8%

[A] Source: Factset, LPL Research, Market Watch, Ned Davis Research. Returns shown are S&P 500 index price returns.

[B] Source: St Louis Fed

And if the capital gains tax rate moved from 20% to 39.6%, a new president and Congress could in three years change it again. Even permanent changes in tax policy are never really permanent.

In some cases, however, accelerating capital gains may make sense. If an investor was planning on selling lower-basis assets in the next couple of years anyway (for example, to reduce concentration risk or to free up liquidity for something else), it is worthwhile to consider selling now ahead of the potential rate increase. Chances are that tax policy passed later in 2021 or early next year would not be retroactive to today,[6] so there likely is still a window to act. Keep in mind the current proposal from President Biden is to only tax capital gains at the highest rate (39.6%) on those with incomes greater than $1 million. Each situation should be assessed individually — for example, a high-income investor about to retire may not face the highest long-term capital gains rate once he is no longer working.

How Will Bessemer's Investment Advice Change if Capital Gains Rates Do Go Up?

We have been managing money for taxable families for over 100 years. As you see in Exhibit 2, the only constant for tax rates is that they change. Rather than be driven by taxes, we will continue to pursue a tax-aware investment approach. We will maintain a long-term investment horizon and focus on what our clients get to keep net of taxes.

We are following the tax proposals closely, but at this point it is too early to tell what the changes will actually be and how we should react. All else equal, if capital

[6] We do not expect individual tax changes enacted during 2021 to be retroactive to today or to January 1, 2021, although it does remain a possibility.

gains rates go up significantly, our holding periods will likely increase, as it becomes even more punitive to sell winners. And tax-loss harvesting becomes even more beneficial in that environment, as losses realized are able to offset gains taxed at a higher rate.[7] Tax-loss harvesting can be done throughout the year, dictated by market conditions, and not just at year end. Further, a higher long-term capital gains tax rate argues for even tighter coordination between an investor's investment, tax, estate, and charitable planning. For example, a charitable-minded client adding money to her investment account over time would likely benefit by donating low-basis assets to charity and replacing those investments by repurchasing them with new cash and resetting to a higher basis. This maintains portfolio integrity, avoids a capital gain on the donated shares, and generates a charitable income tax deduction.

One interesting nuance — if there is no difference between the short-term and long-term capital gains tax rate, investors who want to sell a winner in less than a year no longer have the tax incentive to wait, and this could push holding periods for shorter-term investors even lower.

If the Step-Up in Basis Rules Change, How Will That Alter Bessemer's Investment and Planning Advice?

President Biden's campaign platform and, more recently, the outline for his American Families Plan promote taxing built-in capital gains on death in excess of $1 million. This would be a significant and complex change in tax policy. The Biden team has yet to provide many specifics on how precisely this would work, which makes any planning at this stage difficult, if not impossible. One thing we do know is that, if enacted in full, this could be very expensive for certain taxpayers. For people whose estates consist of mostly low-basis assets and who live in a state with both a state-level income tax and estate tax, the combined estate tax and capital gains tax rate at death could be more than 75% (see Exhibit 4). It is for this reason that we are closely watching the negotiations in Washington on this subject.

Although there are few details now, similar proposals were introduced in the Obama administration and just this past March via a House bill and a Senate "discussion draft" of a bill. From these bills, we can glean some of the issues that may be addressed. All of these proposals grant exemptions when assets are left to charity and sometimes to a surviving spouse. There may also be exemptions for certain items of tangible

Exhibit 4: Tax on Zero-Basis Asset of NYC Decedent Under Biden Proposals and 2021 New York Rates

Key Takeaway: The proposed changes to capital gains tax rates and the step-up in basis rules, if enacted, would result in a very high tax burden for wealthy investors at their passing, particularly for those living in high-state-tax states.

Combined Income Tax at Highest Marginal Rates	
Federal Income Tax	39.6%
Federal Net Investment Income Tax	3.8%
New York State Tax	10.9%
New York City Tax	3.9%
Combined Income Tax	58.2%
Combined Estate Tax	
Federal Estate Tax	40.0%
New York Estate Tax	16.0%
Federal Deduction for NYS Tax	(6.4%)
Combined Estate Tax	49.6%
Assumed Deduction for Reduced Estate Value	
Because of Income Tax	(28.9%)
Combined Estate and Income Tax Marginal Rate	78.9%

Note: The calculation assumes zero-basis assets taxed at the highest marginal rates. The 39.6% federal rate is proposed in the Biden administration's fact sheet for the American Families Plan. The top marginal rates for New York State and City are, respectively, 10.9% on income over $25 million and 3.876% on income over $50,000. The estate tax calculation does not take into account estate tax exemption amounts, also known as the unified credit. We have assumed there will be an adjustment or deduction that allows the estate to be reduced for income tax paid (58.2% of 49.6%); otherwise, the total tax would be more than 100%.

Source: Bessemer Trust

[7] Tax-loss harvesting involves selling an investment, such as a stock, at a loss and using the realized loss to offset a realized gain. To fully benefit from the realized loss, the investor needs to comply with the Wash Sale rules and essentially not repurchase the stock that is sold at a loss for 31 days.

personal property and for assets constituting a family business or farm. And there may be options to defer paying the tax over a period of time (as there is now with the estate tax), albeit with interest. The precise definitions of each of these exemptions and other items will be extremely important.

Although we do not recommend planning around these proposals now, we can begin to see how planning might change if they are enacted. Instead of leaving specific dollar amounts to children and charities, we may recommend leaving particular assets to children (high-basis assets or family business assets) and others to charity (low-basis assets). It may also be that life insurance, which features tax-free growth in cash value and a death benefit, plays a bigger role in planning.

With respect to the decision to sell low-basis assets during life, current investment advice has rightly evolved as an investor's horizon shortens and the investor approaches a step-up in basis.[8] For example, an 85-year-old matriarch in poor health with a large concentration in one stock has likely been advised to hold on to that stock. Historically, her heirs would be able to diversify tax free at her passing, so why sell now and pay a tax her family might otherwise be able to avoid? But if the rules change and the gain will be realized at her passing, she should change course. She and her family should be much more focused on risk reduction, and they would likely benefit by diversifying sooner rather than later. Those who have historically pursued a buy-and-hold approach and hoped to eventually benefit from a step-up in basis may need to reevaluate their strategy if the rules change.

Concluding Thoughts

The future is hard to predict, and tax policy is always in a state of flux. Ideally, client objectives and goals, and not potential legislative changes, should be the primary driver of investment and planning discussions.

In the world of tax, we like to focus primarily on what we know now. Given the mismatch between tax revenue and spending, and the current Democratic agenda and control of the federal government, it does seem likely that tax rates are moving higher. While paying tax sooner than you need to is generally to be avoided, in certain cases, this may be a consideration worth exploring. Now is a great time to check in with your tax, legal, and Bessemer advisors and make sure your plan is on track.

[8] Historically, if an investor had a $1 basis and passed away with a stock worth $10, the basis would be "stepped-up" to $10, and heirs could sell the stock tax free. If these rules change, and there is a deemed realization at death, not only will the step-up in basis be eliminated, but the stock would be assumed to be sold, forcing a $9 capital gain regardless of whether the stock is actually sold or held.

Our Recent Insights

Labor Market Recovery — Investment Insights (May 2021)

Planning for 2021: Biden Individual Income Tax Proposals — Wealth Planning Insights (April 2021)

When Your Child Becomes a Legal Adult — A Closer Look (April 2021)

The Future of Money — Quarterly Investment Perspective (Second Quarter 2021)

Sustainable Investing: The Evolution and Bessemer's Approach — Investment Insights (March 2021)

Planning for Today's Residential Construction Project — Wealth Planning Insights (February 2021)

To view these and other recent insights, please visit www.bessemer.com.

About Bessemer Trust

Privately owned and independent, Bessemer Trust is a multifamily office that has served individuals and families of substantial wealth for more than 110 years. Through comprehensive investment management, wealth planning, and family office services, we help clients achieve peace of mind for generations.

ATLANTA • BOSTON • CHICAGO • DALLAS • DENVER • GRAND CAYMAN • GREENWICH
HOUSTON • LOS ANGELES • MIAMI • NAPLES • NEW YORK • PALM BEACH • SAN FRANCISCO
SEATTLE • STUART • WASHINGTON, D.C. • WILMINGTON • WOODBRIDGE

Visit us at bessemer.com