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President Biden's Tax Proposals

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OVERVIEW

Over the course of his presidential campaign and through the first several months of his presidency, President Biden has publicly announced potential individual and business income tax changes. The changes have morphed and modified over time, with several entirely abandoned. The President and his Administration will be highly influential in shaping tax policy over the coming years. With the power of the pen and the ability to sign a bill into law, the President may be viewed as having the final say on tax changes, but he may not have the first. Tax legislation must originate in the House of Representatives according to the Constitution, and, therefore, Congress will be highly influential in determining tax policy. However, the President's budget introduced on May 28, 2021, will likely set the stage for the shape and scope of anticipated tax changes.

A common thread running through the individual tax raising proposals is the focus on high-income taxpayers. This is intentional. The President seeks not only tax increases to pay for a comprehensive infrastructure bill but also to address a social justice goal: narrowing the gap in income and wealth inequality.

This Tax Alert focuses on individual tax proposals, both revenue-raising measures as well as tax cuts. The Alert also addresses several items that the White House no longer proposes but that could be relevant if Congress resurrects such tax changes.

INDIVIDUAL TAX RAISING MEASURES

The President's individual income tax proposals are contained in his proposed American Families Plan. (The American Families Plan was announced on April 28, 2021, in conjunction with a Fact Sheet released by the White House. Further details were then announced as part of the President's budget on May 28.) In aggregate, the President seeks just over $1.5 trillion in tax increases over the 10-year budget window. The actual revenue raised would be more, since the tax increases would be permanent.

Ordinary Income:

Restore the top income tax rate to 39.6% in 2022 and after (currently the top rate is 37%) and apply that rate beginning at $509,300 for couples ($452,700 for single taxpayers). For 2021, the current 37% top rate applies to income above $628,300 for couples and $523,600 for single taxpayers.

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3625334 6/2021

Dropping the income threshold from $628,300 to $509,300 would expose income between $509,300 and $628,300 to an additional 4.6% in taxes. Income above $628,300 would be exposed to a rate increase of 2.6%. This change would effectively restore the top tax rate and income tax bracket that was in place prior to the Tax Cuts and Jobs Act of 2017 ("2017 Tax Act"). As a result, taxpayers with taxable income of $628,300 would see a tax increase of $5,474 and a taxpayer with taxable income of $1.5 million would see a tax increase of $22,664.

Effective date: The President proposes January 1, 2022, as the effective date for the tax bracket and rate changes.

Revenue effect: It is expected that this provision would raise $132 billion in revenue over the 10-year budget window. All of that revenue would actually be received between 2022 and 2025, since the Trump tax cuts would expire by then and the top rate, by default, would return to 39.6% in 2026.

Capital Gains and Qualified Dividends:

To the extent that a taxpayer has adjusted gross income in excess of $1 million, capital gains and qualified dividend rates on such excess would increase to ordinary income tax rates — 37% for 2021 (for gains realized as early as April 28) and 39.6% for 2022 at that level of income. After factoring in the healthcare surtax, the top rate for such gains (and dividends) would be 40.8% in 2021 (post April 27) and 43.4% in 2022.

The higher rate would apply only to the extent that gains and dividends exceeded the $1 million adjusted gross income (AGI) threshold. The $1 million threshold (which would be adjusted for inflation after 2022) would apply equally for married couples and single taxpayers; however, the threshold would drop to $500,000 for married couples filing separately. AGI is not the same as taxable income: AGI is income before deducting itemized expenses such as state and local taxes, investment interest and charitable deductions. Thus, by pegging a jump in capital gains/dividend rates to AGI rather than taxable income, more taxpayers and more wealth would be subject to the increased rate.

Effective date: The President proposed the "date of announcement" as the effective date for the higher capital gains/dividend rates. Although that is a cryptic term, it is generally thought that April 28, 2021, is the effective date, since that is the date the White House formally announced the American Families Plan, calling for an increase in the capital gains/dividend rates. While April 28, 2021, may be the base case date for the effective date, Congress may have other thoughts on an effective date, particularly if legislation does not pass until late fall.

Revenue effect: It is expected that this provision would raise $322 billion in revenue over the 10-year budget window.

Deemed Sales and Changes to Step-Up in Basis Rules:

Lifetime transfers by gift and transfers at death of appreciated assets would trigger a "deemed" capital gain at the time of the transfer. Transfers at death to a U.S.-citizen spouse or a charity would be excluded.[1] Instead, the spouse would take a carry-over basis, and gain would be recognized when the surviving spouse dies or sooner sells the asset. A deemed gain would not apply to transfers of certain family businesses, and special rules would apply for non-marketable assets. Nor would a gain apply to any tangible items such as furniture and personal effects, unless those items were collectibles. A "portable" $1 million exclusion (plus a $250,000 home exclusion) would apply to each spouse for transfers made either by lifetime gift or bequest. This change would be a fundamental departure from tax policies that have been in place for 100 years, but it would not affect all taxpayers.

The proposal indicates that the basis of property received by reason of death would be the asset's fair market value at the time of the decedent's death, whether shielded by the $1 million exclusion or subject to a deemed capital gains tax. Accordingly, if an estate is under the estate tax exclusion amount and has unrealized appreciation of $1 million or less ($2 million for married couples), there would still be a tax-free step-up in basis at death, as under current law. Thus, it may be imprecise to simply say the elimination of the step-up in tax basis on death puts an end to the step-up in basis. A step-up would be retained for many taxpayers. A similar basis rule applies to gifted property that is not shielded by the donor's $1 million exclusion. However, for gifted property that is shielded by the exclusion, the donee's basis would be the same as the donor's at the time of the gift, potentially making the use of the $1 million exclusion less efficient during life versus at death.

The "bite" of this proposal may be even worse than its "bark." The proposal goes far beyond just triggering a potential gain when property is transferred by gift or at death. Property held in trusts, partnerships, or other non-corporate entities would be subject to a deemed gain on unrealized appreciation if that property has not been the subject of a recognition event within the prior 90 years, beginning on January 1, 1940. Thus, the first possible recognition event would be December 31, 2030.

The proposal would even reach other transfers. Transfers of property into, and distributions in-kind from, a trust, partnership, or other non-corporate entity (other than certain grantor trusts), would be recognition events.

If the above-referenced proposals were enacted, they would bring about significant changes with regard to estate planning. For example, instead of planning to have low-basis assets in a decedent's estate in order to be eligible for a step-up, it might be better to retain high-basis assets in the estate to avoid or reduce a deemed sale.

Effective date: The President proposes January 1, 2022, as the effective date for deemed sales and changes to the step-up rules.

Revenue effect: The revenue expected from this change is part of the capital gain revenue and is included in the estimated $322 billion of additional revenue from that source.

[1] The transfer of appreciated assets to a split-interest trust would generate a taxable capital gain, with an exclusion allowed for the charity's share of the gain based on the charity's share of the value as determined for gift or estate tax purposes.

Like-Kind Exchanges:

Allow IRC §1031 deferral of gain up to an aggregate amount of $500,000 for each taxpayer ($1 million for couples) each year for real property exchanges that are considered like-kind. Currently there is no limitation of the gain that can be deferred. Excess gains would be recognized by the taxpayer in the year the taxpayer transfers the real property subject to the exchange.

Effective date: Effective for exchanges completed in taxable years 2022 and after.

Revenue effect: It is expected that this provision would raise almost $20 billion in revenue over the 10-year budget window.

3.8% Health Care Surtax:

Taxpayers with adjusted gross income in excess of $400,000 would generally be subject to a 3.8% surtax on gross income and gain from any trades or businesses that are not otherwise subject to employment taxes. This expansion of the Health Care Surtax will particularly affect S corporation owners who currently are not subject to self-employment taxes on pass-through income. This 3.8% surtax will equal the payroll tax that would be due if the S corporation pass-through income were paid to the owner in the form of wages instead.

Effective date: This change would be effective beginning in 2022.

Revenue effect: It is expected that this provision would raise about $237 billion in revenue over the 10-year budget window.

Excess Business Loss Limitation for Individuals:

Federal tax laws limit the extent to which pass-through business losses can be used to offset other income. Losses can be deducted unless they exceed certain limits, in which case they are carried forward to future years as net operating losses. The rule was enacted as part of the 2017 Tax Act and is expected to expire in 2027. The President proposes to permanently extend this limitation rather than letting it expire.

Effective date: This change would be effective beginning in 2027.

Revenue effect: It is expected that this provision would raise about $43 billion in revenue over the 10-year budget window.

Tax Compliance and Reporting:

The President proposes a multipronged approach to increasing tax revenue through tax compliance measures and new reporting obligations.

IRS Funding — First, the President proposes to increase IRS funding by $6.7 billion (in addition to $72.5 billion in mandatory funding) and direct the additional resources towards enforcement against taxpayers with income over $400,000.

Reporting — Second, the President would require financial institutions (and crypto asset exchanges and custodians) to report data on personal and business financial accounts in an annual information return. The new report would include gross inflows and outflows with a breakdown for physical cash, transactions with a foreign account, and transfers to and from another account with the same owner. The Administration notes that the tax gap for business income (outside of large corporations) is $166 billion a year and that the revenue loss is driven primarily by the lack of comprehensive information reporting and the resulting difficulty identifying noncompliance outside of an audit. The proposal further notes that while the net misreporting percentage is only 5 percent for income subject to substantial information reporting, the net misreporting percentage for certain categories of business income exceeds 50 percent.

Enhanced crypto asset reporting, including beneficial owners of entities holding crypto, would also apply.

Effective date: This change would be effective beginning in 2023.

Revenue effect: It is expected that these changes would raise $779 billion in revenue over the 10-year budget window.

TAX CUTS

President Biden's fiscal year 2022 budget is heavy on tax-raising measures but also contains several tax cuts aimed at lower income earners.

Earned Income Tax Credit (EITC):

This was expanded under the American Rescue Plan Act of 2021 (known to many as the March 2021 Covid-19 Stimulus Bill). The proposal would permanently extend the expansion of the EITC for workers without children.

Effective date: beginning in 2022

Child and Dependent Care Tax Credit (CDCTC):

This was expanded under the American Rescue Plan Act of 2021. The proposal would permanently extend the expansion of the CDCTC and would establish reporting requirements appropriate for an expanded refundable tax credit.

Effective date: beginning in 2022.

Child Tax Credit (CTC):

This was expanded under the American Rescue Plan Act of 2021. The proposal would (1) extend the changes to the CTC through 2025, (2) increase the age to qualify for the CTC by one year to include children who are 17 years old, (3) increase the maximum credit per child to $3,600 for qualifying children under 6 and to $3,000 for all other qualifying children, and (4) allow 50% of the credit to be paid in advance based on information on the previous year's income tax return.

Effective date: beginning in 2022.

Premium Tax Credits for Affordable Care Act:

The premium tax credits for the ACA, which were expanded under the American Rescue Plan Act of 2021, are based on household

income and family size. The American Rescue Plan decreased the applicable contribution percentages and extended credit eligibility for taxable years 2021 and 2022. The President's proposal would make permanent the recent decrease in the applicable contribution percentages of household income used for determining the credits. The proposal would also make permanent the credit eligibility to taxpayers with household income above 400% of the federal poverty levels.

Effective date: The proposal would be effective in 2023 and after.

Revenue effect: It is expected that the foregoing tax cuts would cost $822 billion over the 10-year budget window.

BIDEN'S PRIOR PROPOSALS — OMITTED FROM CURRENT TAX PLAN

Estate, Gift and GST Taxes. Before the 2020 elections, there was much speculation around estate tax changes, and particularly around reducing the estate tax exemption and increasing the estate tax rate. Biden's proposal for estate taxes was (i) to restore the estate tax to 2009 levels (presumably this would also include the 2009 parameters for gift and GST tax) and (ii) to eliminate the step-up in basis of a decedent's assets to date-of-death values.

While Biden's estate tax proposal was bare-bones, it has long been a desire of many Democrats to modify the estate tax laws. Such modifications may mean not just lower exemptions and higher rates but also the elimination of valuation discounts and the restriction of other popular estate planning techniques, such as grantor retained annuity trusts (more commonly called GRATs).

In 2021, a bill called "For the 99.5 Percent Act," sponsored by Senator Bernie Sanders, called for increasing rates to as high as 65% and dropping the estate exemption to $3.5 million, along with curtailing discounts and certain other estate planning strategies.

The American Families Plan does not include any changes to the estate, gift, or generation-skipping tax rates or exemptions. Even without such changes, the transfer tax rates and exemptions are still scheduled to be significantly changed beginning in 2026. Even though Biden is no longer proposing estate tax changes, taxpayers should carefully consider the merits of estate planning in the near term, and perhaps even before year end, for the following reasons: (1) Congress could include in legislation provisions changing estate tax rules, (2) the current favorable estate tax exemptions expire at the end of 2025, and (3) under Biden's proposal a transfer of appreciated assets by gift beginning in 2022 could result in a deemed capital gain.

Limitation on itemized deductions. The Biden campaign proposed limiting itemized deductions for certain taxpayers in two ways. First was to restore a phase-out of itemized deductions that was in place prior to the 2017 Tax Act. Second was to limit the benefit of itemized deductions that would be allowed to the 28% tax bracket for taxpayers in higher brackets. The combined effect of these two proposals (reducing the amount of deductions and limiting the benefit) would effectively be a tax increase on high-earning taxpayers. So far these have not been included in the tax changes proposed by the President. It should be noted that the phase-out of itemized deductions is scheduled to return in 2026 upon the sunset of the 2017 Tax Act.

Qualified Business Income Deduction. Biden has also proposed phasing out qualified business income deductions for those earning more than $400,000. Under the current law, which expires at the end of 2025, non-C-corporation taxpayers are permitted to deduct 20% of their business income from either pass-through entities or qualified real estate investment trusts. The President has backed away from this prior proposal.

Social Security Taxes. Currently, Social Security tax is imposed on a worker's wages up to $142,800 per year at a rate of 6.2% for both the employee and the employer (12.4% total tax). Previously, Biden proposed applying the Social Security tax on all wages over $400,000 at the same rates. This provision has been absent from the tax changes proposed by President Biden.

Retirement plan contributions. Workers are generally permitted to take an income tax deduction for contributions to employer-sponsored retirement plans, such as 401(k) plans. The value of an income tax deduction is greater when a taxpayer is subject to a higher tax rate, meaning that a deduction provides a greater tax savings for high earners. Biden has previously proposed replacing the deduction with a tax credit, which could effectively provide the same dollar amount of tax savings to all taxpayers, or even be structured to provide a greater benefit to lower earners by phasing out the credit for higher income individuals. This change has not been included in the President's latest tax proposals.

CONCLUSION

It is important to note that these are only proposed tax changes. It is a long way from proposal to passage. Narrow majorities in Congress, a lack of Republican support for any tax increases, and divisions within the Democratic Party itself will make for a long path from proposal to law.

It is likely that any tax changes will be passed using the reconciliation process which avoids the prospect of a Republican led filibuster. However, reconciliation is a complex and often time consuming process, and it limits both the scope of a bill and the circumstances under which such a bill can be introduced. To that point, it remains to be determined whether certain proposals may even be included in a reconciliation bill.

What is known is that Biden and the Democrats campaigned, and ultimately prevailed, promoting a platform that advocated for improvements to infrastructure and advancing social justice programs, both of which come with large price tags. With control of both chambers of Congress and the White House, one should anticipate that Democrats will try, and in some respects succeed, in moving forward this agenda, including generating the increased tax revenue to help fund these objectives.

—National Wealth Strategies, Chief Investment Office

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