PERSPECTIVE

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Biden's Proposed Tax Increases Will Hurt, Especially in California

By Robert W. Wood

There's an old adage about tax increases not being wise in an election year. But some tax increases are more likely to be popular than others. And the most popular tax increases these days are those that target wealthier people and companies. It does not seem likely that major tax increases will pass—or perhaps be voted on at all—until after the election. But it is still worthwhile to look at what the President is proposing.

When it comes to his budget and the taxes that are needed to pay for it, President Joe Biden is thinking big. The president's FY 2025 budget is a whopper at $7.3 trillion, and the budget floats some serious tax increases, too. As you might predict, much of the focus is on getting higher income taxpayers to pay more.

Higher Rates

Currently, the top federal rate on ordinary income is 37%. Biden has proposed increasing it to 39.6%, which was the top rate back in 2017. Starting in 2018, President Donald Trump signed into law the Tax Cuts and Jobs Act that made many cuts, including the 2.6% cut to the top ordinary income tax rate. Notably, though, the new 39.6% rate is only supposed to apply to taxpayers making $400,000 or more.

Capital Gain Tax Increase

If you sell your stock, property or crypto and you've held it for more than one year, you get a classic tax break. Long-term capital gains are taxed at lower rates than ordinary income. But how much lower depends on your income. If your taxable income is $47,025 or less, you pay zero tax on your long-term capital gain. If your taxable income is from $47,026 to $518,900, you'll pay 15% on your long-term capital gain.

If your taxable income is more than $518,900, you pay 20% on your long-term capital gain. Under current law, even if you have millions in long term gains, your top capital gains tax is 20%. But before we discuss Biden's proposal, it's important to note that many long-term capital gains are *also* subject to the net investment income tax, sometimes called the Obamacare tax.

That is another 3.8%, bringing the typical top tax rate on long-term capital gains to 23.8%. This 3.8% net investment income tax applies if you have modified adjusted gross income above $250,000 if you are married and filing taxes jointly. If you are single, the threshold is $200,000.

How would the capital gains tax change under Biden's FY 2025 budget proposal? For high income taxpayers, the long-term capital gains tax could nearly double to 39.6%. That proposed capital gains rate increase would apply to investors who make at least $1 million a year. In fact, it is possible to go even higher, as high as 44.6%. Portions of the General Explanations of the Administration's FY 2025 Revenue Proposals note that for some taxpayers, if you add several proposals together, they could increase the top marginal rate on long-term capital gains and qualified dividends to 44.6%. It seems unlikely that this major capital gains tax change will be enacted, but time will tell.

Medicare Tax

President Biden is proposing a tax increase for people making more than $400,000 a year to help finance Medicare. The increase would hike the Medicare tax rate from 3.8% to 5%.

1031 Exchanges

Section 1031 is one of the few sections of the tax code everyone seems to know. It is even routinely used as a verb. Under 1031, if you exchange real estate for like-kind real estate, the gain is postponed until you sell your replacement property. Properties are of like-kind if they are of the same nature of character, whether they're improved or unimproved. For example, an apartment building would generally be like-kind to another apartment building. Starting in 2018, swaps of Bitcoin for Ethereum, exchanges of private aircraft, paintings, or coin collections don't qualify. Only *real estate* qualifies, and it must be of like-kind. It has to be business or investment property, not your personal residence.

Still, improved real estate can be exchanged for unimproved real estate. And city real estate can be exchanged for a ranch or farm. The real estate industry has counted on this provision for generations, but President Biden's FY 2025 budget would repeal this code section. The White House has said that it "amounts to an indefinite interest-free loan from the government."

No More Carried Interests

Some fund managers are able to treat certain types of carried interests as a long-term capital gain, even though they receive the interest as part of their pay. This provision of the law has long been criticized, and the Biden budget proposal would treat these interests as ordinary income for federal income tax purposes.

Billionaire Tax

President Biden also wants to impose a minimum tax on billionaires. The provision is controversial in part because it is a type of wealth tax rather than a traditional income tax. Despite the billionaire label on the proposal, this new tax would also apply to people who are wealthy but a long way from being a billionaire. If passed, the billionaire tax would be a minimum of 25% for households with net worth exceeding $100 million.

Corporate Tax Rates

Finally, how about corporate tax rates. The so-called Trump tax law—the proper name is the Tax Cuts and Jobs Act—was passed at the end of 2017. Among other things, it slashed corporate tax rates from 35% to 21%. Business groups had railed for decades about how comparatively high U.S. corporate tax rates were compared to nearly every other foreign country.

But while business was happy with 21%, President Biden vowed to change it, either back to 35% or at least somewhere north of 21%. The President's 2025 Budget wants the corporate income tax rate increased to 28%. That would be a big change, but there are other proposals too. The President's Budget also denies corporations tax deductions for all compensation over $1 million paid to any employee.

California Taxes?

Will the proposed federal tax hikes hit harder in California than say, Texas, Nevada, Wyoming, or Florida? In a sense, yes, since California taxes are themselves quite high. If you live in California, the top California income tax rate has been 13.3% for a decade, but effective on January 1, 2024, the *new* top rate is an eye-watering 14.4%. The new 14.4% rate is the result of no limit on California's 1.1% employee payroll tax for State Disability Insurance. It translates to a top 14.4% rate for those earning over $1 million.

California's 13.3% rate still applies to capital gain, which has long been an irritant to California investors. At the federal level, the capital gain rate is currently 20% for higher income taxpayers. Add the 3.8% net investment tax under Obamacare, and you have 23.8%. By paying 23.8% plus 13.3%, Californians are paying more on capital gain than virtually anyone else in the *world*.

But can't you just deduct your California taxes on your federal tax return? Not always, as there is a general $10,000 cap on state and local taxes that you can claim on your federal return. There's been some relief from this ceiling via pass-through entity elective tax that allows some people to deduct more, but it is tricky and not applicable to everyone.

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