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Upcoming Tax Changes Could Hit Californians Harder Than Most

By Robert W. Wood

Several factors are converging that virtually ensure tax changes next year, creating a perfect storm for adjustments. For one thing, the Trump tax cuts passed in 2017 that took effect in 2018 are scheduled to expire at the end of 2025. That means many tax changes, even if Congress does not take action. For example, if Congress does not act, the standard deduction for a married couple will fall to approximately $16,525 in 2026. But if the 2017 law is extended, the standard deduction will be roughly $30,725. Should the tax cuts expire, there will also be a much smaller exemption from gift and estate taxes, changes in income tax rates, and more.

Even more imminently, there is the election this November. Every week, if not every day, you hear tax code changes being floated or promised by the candidates. For example, former President Trump has said that he'll levy no tax on tips—and then Vice President Harris agreed—whereupon Trump proposed no tax on overtime. And so it goes. Of course, Presidents can't make tax changes by themselves; they need the House and Senate on their side. But with many hotly contested Congressional seats up for grabs this year, it's not unrealistic to imagine a unified government in 2025, where the President's partisan tax proposals are all but guaranteed to pass.

Regardless, both Vice President Harris and former President Trump are regularly touting tax changes they say they will make if elected. Harris proposed a 28% tax on long-term capital gains for Americans who earn $1 million or more. Are higher taxes for high income taxpayers a surprise from a progressive Democrat? No, but perhaps it is all relative. President Biden had wanted high income taxpayers to pay the same tax rates on capital gains as they do on ordinary income, up to 39.6%.

In that sense, Harris' floated capital gain rate was a surprise. Clearly, 28% would be a significant hike from the present 20% rate for higher earners. Even so, Senator Bernie Sanders quickly expressed disapproval, urging Harris to aim for higher rates on upper income taxpayers. However this shakes out, it could hurt top earners, particularly in high-tax California. Although all eyes now are on the federal election, and what it could do to tax rates, it's hard to talk taxes in California without addressing the elephant in the room: state taxes administered by the Franchise Tax Board.

For a decade, the top California income tax rate was 13.3%, but effective on January 1, 2024, the *new* top rate shot up to an eye-watering 14.4%. That is the highest ordinary income rate now, but surely like the feds and like most states, there's got to be a better deal for capital gains, right? Not really. California *does* allow a modest tax break for capital gain, but it's so small that it seems hard to call it a break. The 13.3% rate applies to capital gain at higher incomes, and that kind of unified rate structure has long been an irritant to California investors. Currently, the top federal capital gain rate is 20%. On top of that, you must add the 3.8% net investment tax, bringing you already to 23.8%.

Even without a rate increase, by paying 23.8% plus the state rate of 13.3%, you can reach a grand total of 37.1% on long term capital gains. In fact, if you look at other states and even other countries, Californians are paying more on capital gains than virtually anyone else in the *world*. If Harris' 28% on capital gain is approved, keep in mind that you will *still* need to add the 3.8% net investment income tax, plus the 13.3% California tax, for a whopping 45.1% rate on long term capital gains for higher income Californians.

Higher tax rate pressure could mean that a few more Californians might consider moving away for tax reasons. I see it regularly, and many other tax lawyers probably do too. Sometimes it is a move before a big income event, such as a lawsuit settlement, stock or crypto sale, or sale of a company. But sometimes it a more general and long-term malaise about California taxes. Of course, most moves involve additional factors besides taxes.

Returning to the smorgasbord of tax proposals, ordinary income may go up too, as Harris wants to raise the 37% top rate back up to 39.6%. Harris has also proposed many *other* tax ideas, largely tracking those proposed by Biden. For instance, she repeated his promise to avoid increasing tax for Americans making less than $400,000, expressed support for an expanded child tax credit, and embraced his so-called Billionaire Minimum Income Tax, a 25% minimum income tax on households worth more than $100 million.

A similar pattern can be found in her proposal to raise the corporate tax rate from 21% to 28%. For many years, the corporate tax rate was 35%, until it was slashed to 21% by former President Trump in 2017. Lately, Trump has said that he wants to cut the 21% corporate tax rate even more. Conversely, in her 2020 presidential campaign, Harris promised to reverse this cut *entirely,* bringing the rate back up to 35%. In 2024, her 28% plan backtracks on this promise.

A few of her other recent proposals may also seem a bit more pro-business. For example, Harris proposed an expanded tax deduction for new small businesses, providing a deduction of up to $50,000 in eligible startup expenses, a marked increase from the $5,000 deduction available today. She also promised to cut some of the bureaucratic red tape burdening small businesses, making it easier to operate and further incentivizing growth.

Some of Harris' more populist tax ideas deviate from Biden's agenda, and as noted, she even echoed former President Trump's proposal to end the federal income tax on tips. Among Harris' tax plans, most are predictably tax increases, some of them major. Stock buybacks are currently taxed at 1%, but she wants it quadrupled to a 4% excise tax. She also piggybacked on Biden's controversial plan to tax certain unrealized capital gains, an arguably scary concept that would operate as a kind of wealth tax. You would have to pay this tax even if your gain is unrealized—that is, even if you don't sell the asset in question.

On the other side of the income spectrum, she has offered tax credits to eligible renters below a certain income level. She also has proposed refundable tax credits to individuals making below $50,000 through her LIFT the Middle Class Act, as well as an expansion of the Earned Income Tax Credit, which benefits lower-income workers.

It's still too early to have a clear idea of exactly what's in store for tax this upcoming year. But in my view, taxpayers should prepare for change. And even without any tax legislation in California, given the already high rates prevailing in the Golden State, higher federal rates can be especially noticeable for higher-income Californians.

Robert W. Wood *is a tax lawyer with www.WoodLLP.com, and the author of "Taxation of Damage Awards & Settlement Payments" (www.TaxInstitute.com). This is not legal advice.*