Over the past few weeks, President Biden has proposed the $2.3trn American Jobs Plan and the $1.8trn American Families Plan, totaling roughly $4trn in additional spending on top of the $4.6trn of fiscal stimulus the government has used to boost near-term economic growth in the face of the COVID-19 pandemic. At this point the details are uncertain as negotiations have not begun in earnest and there is meaningful divergence in the expectations across both policy and market observers. While there is substantial uncertainty about which proposals will actually make their way into law, we wanted to use this communication to outline the current proposals and detail what we'll be watching for as legislative outcomes clarify.

While the Biden administration has stated a preference to pass legislation with bipartisan support, it currently appears most likely that both bills will be passed through a process known as reconciliation which enables the Senate to pass budget-related legislation without it being subject to filibuster by the minority party.

The method by which the plans pass will determine the timing of the bills, although in every case the Democrats will want to fast track the passage as quickly as possible to front load spending prior to the 2022 mid-term elections.

In terms of overall impact from tax increases, Bridgewater[1] estimates that the currently proposed plan would represent a roughly 4-6% tax rate increase on average "representing the largest tax increase on the very wealthy since FDR, though rates would still be lower than in the 1970s." Ultimately the biggest question we are trying to answer is *How does this impact our clients and what should we do now?* We believe the main considerations for investors should include:

1) **Impact on overall risk market levels** – *Will the plans cause the market to go up or down?*
2) **Relative performance of various sectors of the market** – *What sectors are likely to do better?*
3) **Impact of changes in capital gains** – *Should anything be done with current gains given potential changes?*
4) **Impact of changes to step-up in basis and/or estate tax exemption limits** – *Do estates need restructuring ahead of or as a result of tax changes?*
5) **Impact of changes to marginal income tax rates and/or state and local tax (SALT) deductions** – *Are there ways to adjust sources of income?*

In what follows we attempt to lay out our thinking about each element of Biden's proposals and draw what conclusions we can from what we know today, though given the high degree of uncertainty, we are not making or suggesting large adjustments to client portfolios or financial plans. Our primary view is that we must wait, prepare, and watch developments closely.

We begin by providing a bit more detail on the proposal.

Background on Proposal

The table below shows a high-level breakdown of the proposal from both a spending and tax perspective.

Spending		Biden Proposal ($bn)	GT's Best Estimate
Infrastructure			
Buildings/Utilities		689	689
Transportation		621	621
In-home Care		400	400
Jobs and Innovation		578	578
		2288	2288
Families Plan			
Tax Credits (Child, Earned Income)		800	800
IRS/Tax Compliance		80	80
Child/Family Support		495	495
Education		511	511
		1886	1886
TOTAL SPENDING		**4174**	**4174**

Taxes	Current %	Biden Proposal %	Biden Proposal Revenue Generated	GT's Best Estimate %	GT's Best Estimate Revenue Generated
Corporate Taxes					
Corporate Tax Rate	21.0%	28.0%	740	25.0%	423
Minimum tax on GAAP		15.0%	135		135
GILTI	10.5%	21.0%	500	15.0%	250
Eliminating Subsidies to Fossil Fuel Companies			35		35
Personal Taxes					
Top marginal rate	37.0%	39.6%	100	39.6%	100
Long-term capital gains rate for those >$1mm AGI	20.0%	39.6%	400	28.0%	163
Eliminate Step-up in basis					
Close carried interest and real estate loopholes					
Expand medicare tax surcharge for those making above 400k			200		200
Permanently extend current limitation on large business losses			100		100
Tax Compliance			700		350
TOTAL TAX REVENUE INCREASE			**2910**		**1756**
NET SPENDING - TAX REVENUE (FINANCED WITH DEBT)			**1264**		**2418**

Source: https://home.treasury.gov/system/files/136/MadeInAmericaTaxPlan_Report.pdf https://www.crfb.org/blogs/whats-president-bidens-american-families-plan

[1] The Biden Tax and Spend Plan & The Big Cycle Swing, published May 3rd, 2021 by Ray Dalio https://www.linkedin.com/pulse/biden-tax-spend-plan-big-cycle-swing-ray-dalio/?published=t GenTrust does not provide legal, tax nor accounting advice. Any statement contained in this communication concerning tax matters is not intended or written to be used for the purpose of avoiding penalties imposed on relevant taxpayers. Please refer to additional important disclosures at the end.

President Biden's proposals constitute the wish list. We believe the passage of these proposals will prove challenging as Democrats have very small majorities in both the House and the Senate (51-50 with VP Harris) and Republicans have expressed no interest in passing any tax increases. The Democrats have access to the budget reconciliation maneuver which they previously used to avoid a Republican filibuster in the Senate and pass the $1.9trn COVID-19 stimulus bill without any concessions to Republican priorities. A similar process can be expected this time. If everything that is proposed does not pass, it will likely be due to disagreements on the Democrat side, rather than a failure to reach compromise with the Republicans. Further, a few items may slip through the mix because they may not fit within the rules for reconciliation.

How Does This Impact Our Clients And What Should We Do Now?

Overall Market Levels

Overall market impacts from any passed legislation would be determined by the balance of taxes and debt to fund the spending as well as the longer-term impacts of policy on economic productivity. The greater amount that is financed with debt (the lower the amount taxes are raised), the more near-term positive stimulus that results, accompanied by higher debt levels along with potentially higher interest rates, higher inflation and a weaker US dollar. The decision of the debt/tax split will be made on political grounds. The current proposals call for zero debt financing and a 100% tax funded spending. This is not where the political equilibrium lies. As a result, the deliberation process will likely converge to an agreement that is lighter in taxation than the initial 100%, and heavier on debt. Our base case estimate right now is the net amount of addition of debt (spending not financed by increased taxes) could be in the $2-2.5trn range. If this is the case, it would represent roughly 10% of GDP (albeit spread out over 8 years) and could stimulate the economy in the near term.

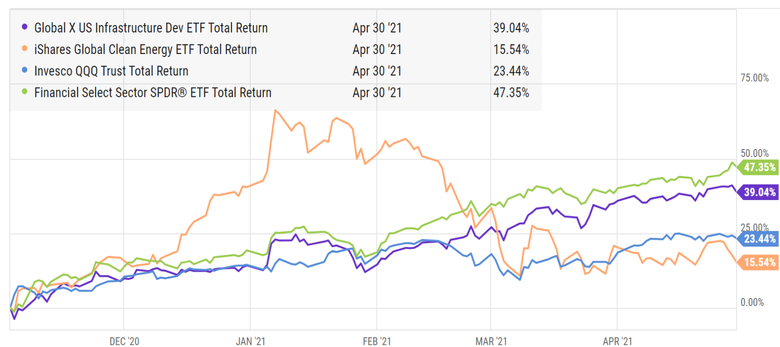
However, the level of debt vs increased taxes is not the only determinate for the overall impact on markets. Increases in corporate tax rates from 21% to 25% (which we view as more likely than the 28% proposed) and the adoption of a new global tax framework including a minimum tax on GAAP income and higher GILTI rates could reduce earnings on the order of 5-10%. In addition, any increases in the capital gains rate that would be made effective in 2022 could create a wave of selling of highly appreciated equities.

That said, investors may not on net change their positioning; so the selling pressure could be short lived. And further if the capital gains tax rate change is made retroactive to the start of 2021, which was the case with the capital gains rate increase in the 1990s, there would be little incentive to sell.

At this stage, given that so many unknowns, we view the risks to the market as balanced and are not changing our overall risk positioning. We do continue to hold our bias towards higher inflation which we view as possibly accelerating if many of the spending plans listed above are passed.

Relative Performance of Sectors

President Biden's spending priorities will determine which sub sectors of the economy will receive an exogenous positive shock and the taxing priorities will determine which sectors of the economy will be hit. On the benefit side, infrastructure and clean energy are obvious beneficiaries. On the negative side, the sectors which are expected to be most impacted by potential tax increases are technology, communications and financials. Looking at the relative performance of these sectors since the start of the year shows some interesting results. It appears most of the positive infrastructure news was absorbed by the market immediately following Biden's election, whereas the negative news from potential tax increases seems largely to have been ignored. For example, the clean energy ETF ICLN was up as much as 66% from Nov 3rd 2020 to Jan 7th 2021, but has since fallen. It's now only up 15% since Election Day and has fallen 5% since Mar 31st 2021 when President Biden's plans were officially announced. The Infrastructure focused ETF PAVE was up 35% from Nov 3rd 2020 to President Biden's plan announcement on Mar 31st 2021 but has barely budged since. Financial stocks (as measured by ticker: XLF) have been largely unaffected by tax concerns and moved higher alongside interest rates, as higher rates offer the opportunity to increase revenue. Technology stocks (as measured by ticker: QQQ) have also been largely immune to the threat of higher taxes.



Source: yCharts

[2]Generally accepted accounting principles, or GAAP, provide the accounting standards that most US companies follow when recording financial transactions and financial reporting.
[3]The global intangible low-taxed income (GILTI) is a category of income that is earned abroad by U.S.-controlled foreign corporations and is subject to special treatment under the U.S. tax code. GenTrust does not provide legal, tax nor accounting advice. Any statement contained in this communication concerning tax matters is not intended or written to be used for the purpose of avoiding penalties imposed on relevant taxpayers. Please refer to additional important disclosures at the end.

Given valuations, recent performance and the proposed spending plans, we think the most compelling portfolio overweight remains our position in clean energy and we'll potentially look to add additional exposure to infrastructure investments.

What is the impact of changes in capital gains rates? Should an investor who makes over $1mm a year in income sell a security that has substantial gains?

The long-term capital gains tax rate is proposed to rise from the current 20% to the top marginal ordinary income tax rate of 39.6% for tax payers with incomes over $1mm. Taxes are not expected to increase for individual taxpayers with incomes below $400k, and likely for joint filers with incomes below $500k. Specific tax brackets have not been revealed yet. We believe it's more likely the capital gains tax rate is returned to 28% where it was in the 1990s. If the move is adopted to higher levels closer to the original proposal, it could have negative impact on stocks that have appreciated considerably in recent years. Other consequences of the increased capital gains tax rate is asset location (which assets are placed in taxable vs tax deferred vs tax exempt accounts) becomes more important. Also trading strategies that generate short term gains become relatively more palatable vs asset classes such as private equity.

Should an investor who makes over $1mm a year in income sell a security that has substantial gains? *In our view* - **No, not right now.** We don't believe there is enough information to make a decision. It remains unclear how much this rate may rise or even if it rises at all. A dramatic increase would likely be reversed down the road, suggesting it makes sense to hold. A smaller increase creates less incentive to sell in the first place Further, it's unclear when the tax changes will become effective. There is precedent to make capital gains tax changes effective back to the start of the calendar year in which the change becomes law. This would make any capital gains rate increase passed this year effective back to Jan 1, 2021. Policy makers may prefer this approach to avoid creating a selling pressure into year-end though making the tax hike effective as of Jan 1, 2022 would create a potential rush to sell assets before year end and raise a lot of tax revenue for the government in 2021.

Thus, we believe the right approach is to wait and see. If a capital gains hike does go into effect, then if it's effective for 2021, there is nothing to do. If its effective only in 2022 and the capital gains tax hike is large (all the way to ordinary income or close to it), then investors need to carefully consider selling in 2021 to pay the lower 20% rate versus holding assets with the expectation that capital gains rates will drop again in the future. Charitable giving of appreciated assets will also become an even more valuable tool in financial planning.

Changes to Estate Tax Law

The administration has suggested removing the step up in the tax basis for the purpose of capital gains on assets in estates at the time of death. We view this as a very controversial proposal and would be difficult for the IRS to administer and the consequences could be dramatic and uneven. President Carter's administration tried something similar and the policy was quickly reversed. Under the current law, individuals have an $11.7mm estate tax exemption above which heirs pay up to 40% on the value of inherited assets. Through thoughtful estate planning, couples can therefore pass $23.4mm to their heir's estate tax free though under current law, this amount declines by more than 50% in 2026. Further under current law there is a step up in basis such that heirs inherit the estate with a tax basis equal to the value upon death. In that way heirs that sell assets out of the estate, either to pay the 40% estate tax or for other reasons, do not owe any capital gains. Needless to say, this has huge value, especially to the heirs of large estates containing substantial long-held appreciated assets. Without a step up in basis, heirs could face a difficult spiral of taxation because assets sold to pay estate taxes would also be subject to capital gains taxes perhaps even at a new higher rate. If assets held in the estate are illiquid and/or difficult to value the difficulties increase even further. Even in the current proposal there are all sorts of suggested carve outs for assets like family farms, family businesses if the heir is involved in the business. The uncertainty around whether this proposal could pass much less the details of how it would be administered if it is passed are massive.

All we can say for certain is that there is potential for estate law changes this year that could have a dramatic impact on high-net-worth families. We are following them closely and clients should be prepared to revisit their estate plans with us and legal counsel in the event new law does in fact take effect.

Conclusion

It's hard to overstate the potential impact of President Biden's proposals. There is potential for both massive spending that will impact every sector of the economy and there's the potential for a huge tax increase that will have substantial impact on both the incomes and estates of the wealthy. However, we view the level of uncertainty around what the actual legislation will include as being equally massive. With this in mind, we've made some portfolio adjustments to take into account what we view as the most likely results of the increase in spending. Meanwhile we are watching developments on tax policy closely and will revert back if an increase in clarity results in a need for action.

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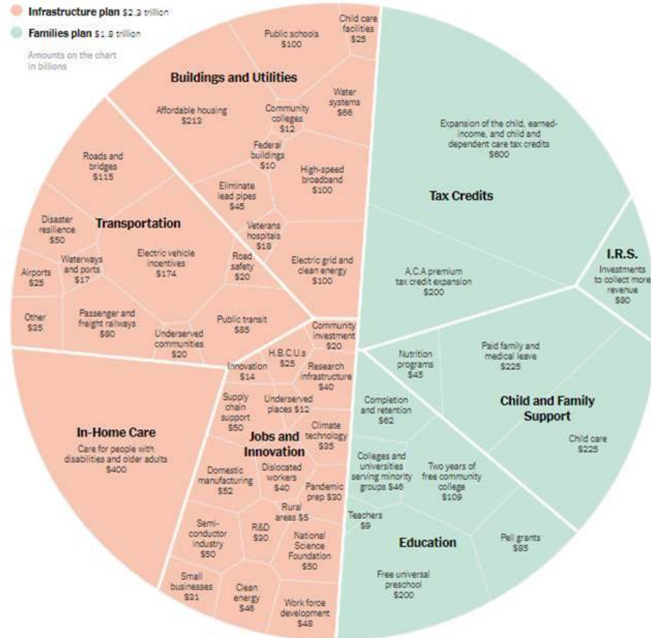
Background Details

Spending Breakdown



Source: Biden's $4 Trillion Economic Plan, in One Chart, New York Times, published: April 28th, 2021 by Alicia Parlapiano

Corporate Taxes

- President Biden proposed raising the corporate tax rate back up to 28% from its current 21% (down from 35% pre-2017)
  - There is resistance within the Democrat party to raise this rate all the way up to 28%. In particular, Senator Manchin of West Virginia has said that he would like the top corporate to not exceed 25%. Given the make-up of the Senate, negotiations will put the top rate at or near 25%.
  - The tax policy center estimates that the original target 7% increase in this rate is expected to bring in about $740bn of income to the government over a 10-year period.
- President Biden also proposes to impose a 15% minimum tax on global book income (GAAP income) on corporations with a net income of $2bn or more. The Treasury estimates that about 180 firms would meet the income threshold, and about 45 would owe the minimum tax. Firms will be allowed to apply for credit for taxes paid above the 15% threshold in prior years. They can also use R&D tax credits, credits for clean energy and foreign tax credits.
- Lastly, President Biden proposes to replace the current tax law on global intangible low-tax income (GILTI) with a 21% country-by-country minimum tax on foreign earnings which is a doubling of the current OECD rate[4] of 10.5%. GILTI is income earned abroad by controlled subsidiaries of US corporations, from easily moveable intangible assets such as IP rights. The tax on GILTI is meant to discourage corporations from moving such assets to low tax locales.
- The administration expects to raise about $2trn in corporate taxes over a 15-year period to pay for spending that is expected to last about 8 years.

Personal Taxes

- The top marginal tax rate is proposed to go up from the current 37% to 39.6%, which was the top rate that existed before the Trump tax cuts in 2017.
- The long-term capital gains tax rate is proposed to rise from the current 20% to the top marginal ordinary income tax rate of 39.6% for tax payers with incomes over $1mm. The long-term capital gains tax rate would also include the 3.8% net investment income tax surcharge put in place to fund Obamacare.
  - Taxes are not expected to increase for individual taxpayers with incomes below $400k, and likely for joint filers with incomes below $500k. Specific tax brackets have not been revealed yet.
  - Market participants believe a more likely outcome would be this rate only rises to the high 20s instead of to the full ordinary income rate.
- Democrat Representatives from high tax states have made it clear they intend to insist that the State and Local Tax deduction (SALT) cap, put in place at $10,000 during the Trump administration's tax reform of 2017, be removed. This would be highly beneficial to high income residents of those states as it would allow them to deduct more, perhaps even all, of the state tax they pay from their income for federal tax purposes.
- The administration is looking to remove the step up in the tax basis for the purpose of capital gains on assets in estates at the time of death.
  - Together with the increase in the capital gains rate, this tax is expected to generate $113bn over a 10-year period.
- In addition, the administration is hoping to improve tax compliance by investing $80bn into the IRS over a 10 year period, and collect $700bn over the same period. The Congressional Budget Office (CBO) is unlikely to recognize the full $700bn for scoring purposes and CBO scoring affects the Senate's ability to use the reconciliation process for passage.

[4]OECD (Organisation for Economic Co-operation and Development) tax rate refers to member countries of this organization. GenTrust does not provide legal, tax nor accounting advice. Any statement contained in this communication concerning tax matters is not intended or written to be used for the purpose of avoiding penalties imposed on relevant taxpayers. Please refer to additional important disclosures at the end.

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