Tax Update

Overview and Summary of Relevant Changes in Tax Law

Last week the House Ways and Means Committee voted to advance new tax legislation. Further negotiation within the House and negotiation with the Senate will likely bring about modifications, but it is worth reviewing the proposal to prepare for potential tactical portfolio adjustments. Similar to President Biden's proposal, the House version would increase the top marginal individual income tax to its prior level of 39.6%. However, many changes are less severe than those previously proposed by the Biden administration.

The long-term capital gains rate would increase from 20% to 25% in the highest bracket, which is far less draconian than an equalization with the proposed short term gains rate of 39.6% under the Biden plan. However, the House plan proposes a 3% surcharge on modified adjusted gross income (MAGI) above $5 million. As MAGI includes most capital gains, the House-proposed tax on long-term gains would increase by eight percentage points. Adding the 3.8% "Obamacare" tax would bring the total marginal rate on long-term gains to 31.8%. This is still meaningfully lower than the maximum proposed short-term rate of 46.4%.

Importantly, the House proposal retains the step-up in basis at death, rather than eliminating it for high-net-worth individuals as was proposed under the Biden plan. This change preserves a substantial tax efficiency in generational wealth transfer. On the other hand, the House plan proposes to reduce by half the federal estate tax exemption level established in 2017 (currently $11.7 million) and substantially tightens the treatment of grantor trusts.

Corporate tax rates would rise from 21% to 26.5% for firms with income above $5 million, versus the 28% rate proposed by Biden. This includes a graduated scale offering lower rates for smaller firms that completely phases out for larger firms with income above $10 million. This would broadly lead to lower after-tax cash flows and potentially have a negative effect on valuations.

Observations

Municipal bonds will retain their tax-exempt status under the House plan. However, a surge in demand could put downward pressure on yields, and we will monitor this effect. Investors may want to consider advancing any planned deployments ahead of the eventual enactment of new tax legislation.

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We pointed out in Greycourt White Paper No. 65 published last fall that as the rate on long term capital gains begins to approach the short-term gain / ordinary income rate, investments that have historically been less tax efficient could become less unattractive. For example, the tax hurdle that high yield bonds or hedge funds need to clear to outperform a more tax efficient investment would be lower, despite overall taxes being higher. Should the House proposal advance further, we believe investors could consider making some related allocation adjustments. Specifically, investors that have been reluctant to diversify by adding taxable fixed income or diversifying hedge funds alongside their municipal bond exposure should revisit this allocation decision on the margin.

We also noted in our earlier white paper that the power of tax loss harvesting strategies could decline as long-term and short-term capital gains rates approach the same level. In the extreme case of equalization as proposed by the Biden administration, estimated tax "alpha" declines from 1.0% to 0.5% annually.[1] The current House plan would incur a lower reduction in tax alpha with only a partial compression of the spread between long and short-term rates. On a related note, Sen. Ron Wyden (D., OR) has proposed closing a loophole that allow ETF providers to use "heartbeat trades" that allow ETFs to swap out low basis positions for new positions without incurring taxes. This may lead investors to consider moving some ETF exposure into tax loss harvesting strategies. Stay tuned.

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[1] https://www.aperiogroup.com/blogs/impact-of-bidens-capital-gains-proposal-on-the-performance-of-loss-harvesting-strategies

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