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American Families Plan Proposes Increasing Taxes on Capital Gains

The Biden administration released the American Families Plan in late April and it included proposals to increase the tax rate on long-term capital gains income over $1 million. Capital gains are the profits from the sale of an asset and generally are considered taxable income. The amount of tax depends on the asset type and holding period. Assets may include real estate, shares of stock, a business or other sizable assets.

Long-term capital gains (LTCG) tax rates in 2020 and to-date in 2021 are 0%, 15% or 20% for most assets held for more than one year. Short-term gains apply to those assets held and sold within a year. The capital gains tax rates on these short-term asset sales correspond to ordinary income tax brackets (10%, 12%, 22%, 24%, 32%, 35% or 37%). The American Families Plan also proposes increasing the highest ordinary income tax rate from 37% to 39.6%, which, when combined with the 3.8% Medicare tax, would raise the top ordinary income tax bracket to 43.4%.

Several changes are proposed for the taxation of capital gains income:

- For taxpayers with adjusted gross income (AGI) of more than $1 million, long-term capital gains and qualified dividends would be taxed at ordinary income tax rates, but only to the extent that the taxpayer’s income exceeds $1 million ($500,000 for those filing married or separate).
    - An example: A taxpayer has an AGI of $1.1 million from $900,000 in wages and $200,000 in long-term capital gains from selling real estate. The taxpayer would have $100,000 LTCG taxed at the preferential capital gains rate and $100,000 at the ordinary income tax rate (because that is the amount that exceeds the $1 million threshold). It is unclear yet whether the $1 million threshold will vary based on a taxpayer’s filing status.
- The top tax bracket also rises substantially for wealthy taxpayers. The capital gains tax rate for households with income over $1 million would increase from 20% to 39.6%, which, when combined with the 3.8% Medicare tax, would be 43.4%.
- Section 1014 of the Internal Revenue Code (IRC) allows heirs to acquire a decedent’s assets with a “stepped-up” basis equal to fair market value on the date of death. This enables beneficiaries to sell inherited assets without realizing a gain due to appreciation at the time of the decedent’s passing (appreciation after the date of death would be a taxable gain). The American Families Plan proposes to end the “stepped-up basis” for gains of more than $1 million (or $2 million per couple). This proposal may result in a deemed sale of assets upon the passing of the decedent.
- For family-owned farms and businesses given to heirs to continue operations, the American Families Plan proposes that the tax on the appreciation would be due only upon the sale of the entity, or when the business or farm is no longer family-owned-and-operated.
- Capital gains treatment for carried interests would end under the American Families Plan proposals, with particular impact affecting hedge fund partners. Currently, a partner who receives a “carried interest” or share of future profits in a partnership in exchange for services is not subject to income tax and may be allocated capital gains from the partnership or realize capital gains upon a sale of the carried interest. Certain holders of

carried interests generally are entitled to long-term capital gains treatment only if they satisfy a three-year holding period rather than the normal one-year period. The plan proposes to modify tax treatment so that hedge fund partners will become subject to ordinary income rates.

- Proposed capital gains tax changes also may lessen the benefit of issuing stock as compensation, for capital gains would be taxable at the same rate as ordinary income.
- IRC Section 1031 currently provides for tax-free like-kind exchanges for real estate over $500,000. The American Families Plan proposes to end Section 1031.
- Charitable donations are not affected by the proposed changes, so no tax on appreciation would apply for a gift to charity. Thus, due to the plan's proposed increase in capital gains rates, gifts to charities would become much more attractive than under current law.

Currently, the IRS has not issued effective dates for these proposals, but tax filers should be aware that possible changes in tax rates are looming. It is prudent to discuss these proposals with your tax advisor to determine if your personal situation may be affected.

If you have any questions on the proposed tax changes or for more information, please contact Frankel Zacharia, LLC at 402.496-9100.