PERSPECTIVE

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Biden's Retroactive 43.3% Capital Gains Tax Hike Looms

By Robert W. Wood

Up until now, the federal income tax rate on capital gain has been zero, 15% or 20%, depending on your income. The long-term capital gain tax is graduated, 0% on income up to $40,000, 15% over $40,000 up to $441,450, and 20% on income over $441,451 (in some cases, add the 3.8% Obamacare tax). In some cases, you add the 3.8% Obamacare tax, but at worst, your total tax bill is 23.8%.

Of course, in California, there is no difference between capital gain and ordinary income rates, so you pay up to 13.3% on everything. In fact, many of the Californians who say they have had enough and move out of state cite the high capital gain tax they pay as a big reason to leave. The 13.3% ordinary income tax rate hurts a lot, but the 13.3% capital gain tax hurts even more. So capital gain rate matters, and right now, the federal capital gain preference is in the cross hairs.

President Biden proposed a 43.4% capital gain rate, but it is supposed to hit only those earning $1 million or more. Of course, if you bought a house many years ago—or if you bought a cash of bitcoin at a low price, that $1 million figure may not look so high after all. You could still be impacted. The top ordinary income rate is 37%, and the president wants to get it back up to 39.6%.

But the proposal that is more radical is to hike the top 23.8% capital gain rate to 43.4%. That would be a staggering 82% increase. If you add state taxes like California's current 13.3% rate the government gets most of your gain. Even more than the rate, though, there's concern about when this could take effect. A natural reaction to a looming tax hike is to sell quickly before the new law takes effect.

But as proposed the rate hike is already in effect for sales after April 28, 2021. It might not pass, or it might pass with a different effective date. But it is hard to decide what to do, especially now that additional proposals seem inevitable as part of the pending infrastructure bill. Do you sell now, figuring you are stuck with higher rates, or do you wait and see? If you wait, might you miss the chance to sell under the old rates?

What if you wait until November and the tax hike passes, but with a September or October effective date? There's no easy answer. If the law passes as proposed, there could be a legal fight too. Are retroactive tax increases constitutional or even fair?

An analysis by Joe Bishop-Henchman of the National Taxpayers Union Foundation's Taxpayer Defense Center says that a retroactive capital gains tax increase, would be unfair to taxpayers and would undermine public respect for the law.

He wrote that retroactive tax hikes violate the fundamental principles of transparency and stability, and prejudice taxpayers' ability to plan their affairs. There is even a question whether retroactive taxation is constitutional. Justice Sandra Day O'Connor once warned that retroactivity over one year would likely violate the Due Process Clause. Justices Antonin Scalia and Clarence Thomas called retroactive taxation "bait-and-switch taxation."

However, these statements are not legal holdings, and it's not clear how the April 28, 2021 retroactive effective date would stand up if the law passes in its current form with that long reach back in time. President Biden may still think the law will pass if his budget is any indication. It assumes that his proposed capital-gains tax rate increase took effect in late April. Of course, Congress hasn't passed it, but the danger grows as Congress considers how to pay for billions of dollars in real infrastructure, and billions more for things called infrastructure that really aren't.

The tax break for long-term capital gains applies to assets held over a year. It covers real estate, stocks and much more. Notably, it includes crypto too, which is itself in Congressional crosshairs in the infrastructure bill. Of course, capital gain tax applies to your gain not to your sales proceeds, so your adjusted tax basis can be subtracted. Your basis is your original investment, as adjusted by things like remodeling costs, expenses related to the investment, etc.

Keep your receipts, which can be relevant for decades with assets like a house. The IRS always wants receipts, and if you can't establish your basis, you could face tax on it all. At least timing is on your side with when to sell. Traditionally, holding until death was also an attractive tax strategy. Sure, the asset would be in your estate for estate tax purposes, but with an over $23 million exemption for a married couple, that isn't such a big deal.

But for income tax purposes, your assets get a stepped-up basis on your death to the full fair market value of the property. This step-up in basis provides tax benefits for everyone passing down appreciated assets, including real estate, stock, family companies and more. Just think about tax-free swaps of real estate. If you make repeated section 1031 exchanges of real estate for years and then die, the appreciation escapes income tax.

Sure, each successive exchange of real estate keeps your old basis, but on death, the basis jumps up to fair market value for income tax purposes. Everyone knows this since for generations, assets held at death have received a stepped-up basis to market value when you die. Small businesses and family farms—everyone really—count on it. And as bad as that 43.4% capital gain tax rate would be, eliminating step-up in basis would be even worse.

Yet President Biden said he would end step up in basis, subject only to an exemption of $1 million plus $250,000 of gain on a home. Beyond that, everything would be taxed, a massive tax increase on death. After the Democratic National Convention, Mr. Biden pledged 'no new taxes' on incomes under $400,000 and on mom & pop businesses. Stay tuned for how this all plays out.

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.*