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Corona Crisis: The USA as a Pioneer of Tax Increases?

The Corona crisis has led to sharply rising national debts worldwide, which are now to be partially paid off by tax increases. Since Biden's presidential candidacy, we have known that a series of tax increases will be imposed on the USA in order to finance the planned projects. But what do the planned reforms entail and how might they affect the capital markets?

Who will pay for this?

Specifically, it involves spending $1.8 trillion on childcare, education and paid family leave, to be funded by tax increases on the wealthiest Americans. The „American Families Plan" comes on top of a nearly $2.3 trillion infrastructure proposal to improve roads, bridges and broadband access, and includes $1 trillion in new spending and $800 billion in tax credits. Biden has so far proposed $6 trillion in new spending, including his Covid 19 relief plan passed earlier this year.

Primarily, the top marginal tax rate would be raised to 39.6% from the current 37% - and the tax rate on capital gains and dividends for households earning $1 million or more would be raised to 39.6% from 20%. This increase, on top of the current 3.8% tax on payroll and capital gains, would raise the top federal tax rate up to 43.4%. In addition, a provision in the tax code that lowers taxes on some inherited assets, such as art, real estate or holiday homes, is to be abolished and the reporting limit from income from the acquisition of real estate is to be capped at $500,000, which could have a major impact on the commercial real estate industry. Add to this a proposal by Biden to allocate USD 80 billion to tax authorities over the next 10 years to double staff and expand capacity to prosecute tax cheats, which government officials estimate could raise USD 700 billion in revenue.

Similarly, there are plans to tax capital gains of people earning more than USD 1 million a year at the same rate as ordinary income. The net effect would be roughly a doubling of the top tax rate on capital gains for top earners, to 43.4% from the current 23.8%, including the 3.8% Obamacare levy on capital gains. This would mean that, for the first time, some Americans' capital gains would be taxed at a higher rate than ordinary income, such as wages and salaries, rather than receiving preferential treatment, as has been the case for most of US tax history.

How realistic are these announcements?

Seeing the plans as more of an opening salvo in a negotiation process, it is believed that the government will aim for a top tax rate of 28% or 30% for millionaire earners, which would be about halfway between the current rate of 23.8% and the top tax rate of 43.4% that is reportedly being considered. In its quest to tax capital the same as labour, the government could also seek to tax dividends at the same rate as ordinary income.

Another alleged goal is to exempt inheritance tax. The government plans to reduce the current exemption amount from USD 11.7 million to USD 5.5 million. However, since the exemption amount for married couples is effectively doubled, the change would only affect a small number of estates. In contrast, eliminating the increase in the cost basis for inherited assets would have a large impact on investments made years ago. Under current law, heirs would only have to pay tax on gains above appreciation when the deceased dies. If appreciation were abolished, heirs would have to pay tax on gains above the original acquisition cost when financial instruments are sold.

But calculating tax on assets that are difficult to value, such as private companies established years ago, can be almost impossible. Even calculating the original price paid for long held, publicly traded shares would be difficult. The reported proposals could also have some unexpected effects, including increased corporate debt. A higher capital gains tax would increase the cost of equity, while an increase in corporate tax rates would lower the cost of after-tax debt. This would have a negative impact on corporate creditworthiness and default risk.

How might stocks and bonds react to an impending tax increase?

Investors could sell assets now to take advantage of the current capital gains rate, as few observers believe an increase would be retroactive. But even if Congress approves an increase - which is highly unlikely given the Democrats' razor-thin majority in the Senate - the impact on stocks and bonds could be limited.

Only 25% of US equities are owned by taxable US investors, with the remaining 75% held by individuals and entities not subject to capital gains tax, such as pension plans and other retirement accounts, endowments and foundations, and foreign investors. And even if the Biden White House tax proposals are almost certainly watered down, there remains some headline risk and, in our view, is always likely to cause temporary uncertainty in the markets. However, the long-term uptrend remains intact, in our view.

In the bond world, bad news can often be good news. While the first quarter of this year was the worst for bonds in more than four decades, we are not yet afraid of further rapid and sharp rises in yields, because a certain rise in inflation is already priced into the markets. The discussion on the topic of „must inflation rise in order to reduce sovereign debt in real terms" is a justified one, but in our view, it will not accompany us this year.

To sum up:

The US tax hikes are part of a long-standing reform plan by Democrats aimed at reducing the country's growing inequality. We do not expect a massive impact on the equity and bond markets but will use temporary emotion-driven price slides for strategic purchases and reallocations. If you want to know how we hedge our portfolios even in volatile times and still profit from the global equity and bond markets, contact your personal Private Banker.

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