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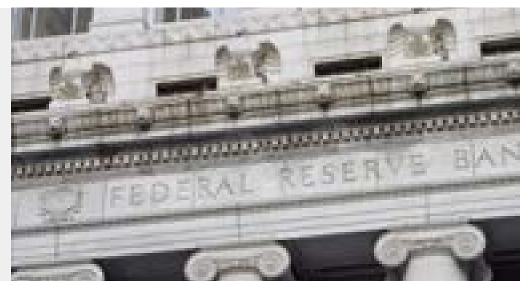
Campaign 2020: An Assessment of the Impact of Biden's Tax Proposal on Investment Returns



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Presidential candidate Joe Biden has proposed an ambitious agenda for tax policy, setting out a series of changes that would increase federal revenues by more than $4 trillion over the next decade. The bulk of this burden would be shouldered by higher income households. Analysis conducted by the Tax Policy Center suggests that 93% of that increase would come from the highest income 20% of households and nearly three-quarters from the top 1%.

The changes to the tax code would be broad, including changes to the corporate tax rate (increasing from 21% to 28%) and assessing Social Security payroll tax on income over $400,000. The changes with the greatest impact on investment portfolios would be:

- Rolling back the Tax Cuts and Jobs Act rates for households earning over $400,000. This would increase the top federal income tax bracket from 37% back to 39.6%. The Net Investment Income Tax (NIIT, aka Medicare surtax, Obamacare tax) of 3.8% would remain in effect, increasing the rate applicable to interest income and short-term gains to 43.4%.
- Taxing long-term capital gains at the ordinary income tax rate for households with incomes over $1 million. This would increase the marginal rate for these high income households dramatically, from 23.8% to 43.4%.
- Taxing unrealized capital gains at death, i.e. eliminating the step-up in cost basis that currently applies.

For households with less than $400,000 of income, the impact of Biden's proposed changes is modest, though taxes remain a significant drag on returns for most investors. For higher income investors the impact could be substantial, especially for those with incomes over $1 million. To assess the potential impact of the proposed changes on investment returns, we've retroactively applied these proposed rates to two types of portfolios:

1. Actively managed equity-oriented portfolios
2. A composite of S&P 500® direct index portfolios

The current results in each chart represent the returns after taxes, based on the highest federal tax rates currently in place. The $400K–$1M scenarios show what the returns after taxes would have been for households in this new income bracket under Biden's proposal (i.e. increasing the ordinary income rate from 37% to 39.6%), and the $1M+ scenarios reflect the higher rates (higher top federal tax rate of 39.6% and capital gains taxed at ordinary income rate) that would apply to those households.

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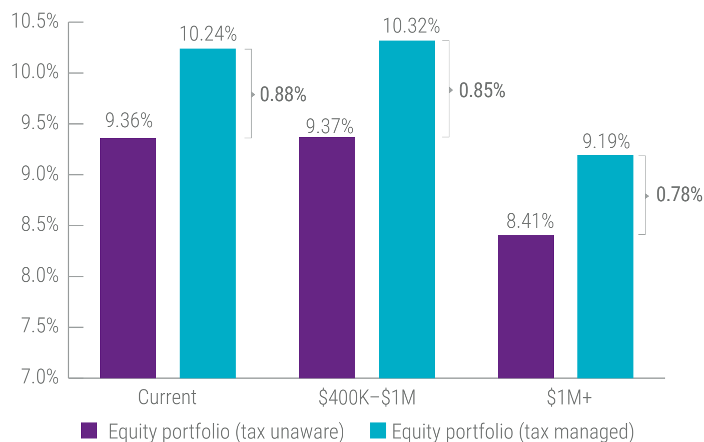
Figure 1: Actively managed equity-oriented portfolio after-tax returns (12/31/11—12/31/19)



Performance data shown represents hypothetical past performance and is no guarantee of, and not necessarily indicative of, future results.

Figure 1 shows the after-tax returns for a multi-strategy portfolio composed primarily of actively managed equity separate account strategies. This portfolio tends to have higher turnover than index portfolios, although realized gains have been predominantly long-term in nature. As shown in the chart, the impact of the proposed changes on investors with household incomes between $400,000 and $1 million would have been negligible. This is not surprising as the main change here is the increase in the rate that applies to short-term capital gains. There is, however, quite a substantial drop-off in the after-tax returns for investors with more than $1 million in income – almost a full 1% decrease in annualized after-tax returns. The benefit of tax management is still apparent, with the tax-managed portfolio outperforming the non-tax-managed version by nearly 0.8% per year.

Figure 2: S&P 500® direct index composite after-tax returns (12/31/09–12/31/19)

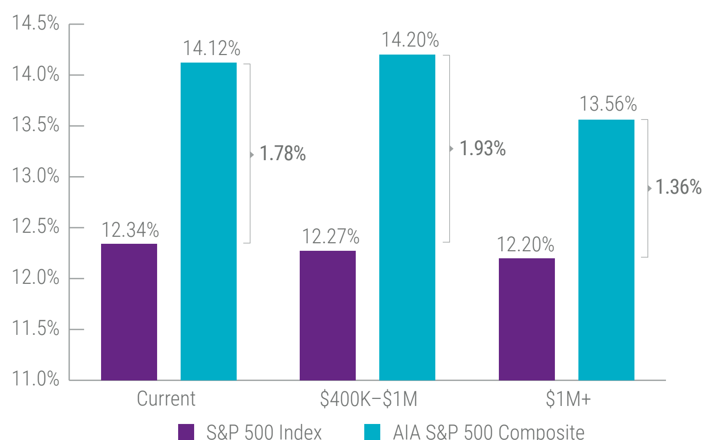


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Figure 2 shows the results for a composite of accounts (i.e. a live track record) managed in a direct index strategy. For the benchmark, the S&P 500® Index, there is little change in after-tax returns for any investors with household income over $400,000 or even $1 million. This is due to the fact that index turnover tends to be quite low, so there are few realized gains. Tax-managed direct index strategies, such as the AIA S&P 500® strategy, typically tend to outperform on an after-tax basis due to the proactive tax loss harvesting techniques employed. Under Biden's proposed changes, the magnitude of this outperformance would not change materially for investors with incomes between $400,000 and $1 million. In fact, it would have been slightly higher under Biden's proposed tax plan (14.20% versus 14.12%). For investors with incomes over $1 million the magnitude of that outperformance would still have been significant (1.36%), but is lower than under the current tax regime (1.78%).

Biden's proposed changes to the tax code are ambitious, and implementing them will likely require that Democrats control both chambers of Congress. Even if he wins the presidential election, there will be obstacles to passing the necessary legislation, though the deficits incurred in responding to the COVID crisis suggest some steps to increase tax revenue will need to be undertaken. As of this writing, Trump has issued only a very non-specific bullet point statement on his tax policy.

To summarize, key conclusions include:

- Tax-managed strategies may add material improvement to after-tax returns. While this may vary by tax rates and strategies used, it may add between 0.8% and 1.9% to after-tax returns.
- For investors with household incomes below $400,000 there would be little change to after-tax returns relative to the current tax regime. Taxes, however, remain a significant drag on investment performance, so considering taxes as part of investment decisions will continue to be important.
- For investors with incomes between $400,000 and $1 million, the impact of the changes also appears to be quite modest.
- The impact is more substantial for investors with household incomes over $1 million, especially for those invested in actively managed strategies. Employing tax-managed strategies will become even more important for these investors.
- Estate planning may need to anticipate the taxing of unrealized gains upon death if the current rules allowing for a step-up in cost basis are changed.

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