Gerry's Journal

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Thoughts on Volatility and Tax Policy

By Gerald B. Goldberg, JD, CIMA, CEO, and Co-Founder

Since March of 2020, domestic and international capital markets have performed exceptionally well. For context, the MSCI World Index (which represents large and mid-cap equity performance across 23 developed countries) has appreciated nearly 93% in just 18 months.[1] This level of asset price growth is extraordinary, especially considering that it has occurred during a global pandemic which has limited economic activity — to some degree — in all corners of the world.

We are not calling for an end to the bull market. However, based on the run-up in equity prices and valuations since March of 2020, some type of pullback should be expected. As we have noted in previous editions of Gerry's Journal, these pullbacks are a normal function of the equity markets, especially following periods of outsized growth.

Historically, these pullbacks have been catalyzed by several factors, including but not limited to:

- Geopolitical events
- Macroeconomic events
- Monetary policy changes (and mistakes)
- Asset bubbles

Thoughts on Recent Volatility

This week, markets opened with another round of volatility on Monday, as equity markets traded sharply lower on the day. One event that was cited as a driver of this selling pressure is the seemingly inevitable insolvency of The Evergrande Group, a China-based property developer. Specifically, the market's concern centers around how the real estate giant's collapse could impact China's economy[2], which has been a key driver of global growth for more than a decade.

The situation with The Evergrande Group is certainly worth following, and we will be monitoring it closely. However, in our view, the recent downdraft in the market is more likely the result of equity prices getting a little ahead of themselves coupled with lingering concerns as to how the COVID-19 pandemic will proceed moving forward. Over the last week, an average of 148,000 Americans contracted COVID-

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1 MSCI, *MSCI World Index* (link)

2 The New York Times, *Why China's Economy Is Threatened by a Property Giant's Debt Problems*. (Link)

19 each day[3] — a stark reminder that while significant progress has been made, the exact path forward is still uncertain.

Additionally, concerns around tax policy may once again be weighing on markets. On September 13, the House Ways and Means Committee unveiled a government-funding proposal that included several proposed tax increases and reforms. Our stance on higher taxes and their impact on markets remains the same: while we are not jumping for joy over the prospect of higher taxes — and there are certainly potential implications for what is being proposed — higher taxes by themselves have not historically had a negative impact on the capital markets.

To this end, we remind readers of our analysis in the August 2020 edition of Gerry's Journal that compared U.S. stock market performance to their prevailing tax environments. In that edition, we noted:

> *While there are numerous factors that move the capital markets, to gain additional insight on how tax rates influence markets, we looked back at past bull markets and the tax environment in which they existed. The U.S. economy has seen 13 bull markets since 1932, with each one lasting an average of 63 months and returning an average of 183%. At the start of these bullet markets, it is notable that the top personal rate has ranged from 35% to 91%, and the top corporate rate (before the TCJA legislation was passed in 2017) has ranged from 35% to 52%.*[4]

[3] The New York Times, *Coronavirus in the U.S.: Latest Map and Case Count* (link)

[4] GYL, *2020 Election Analysis: What Does a Biden-Harris Ticket Mean for November's Election and What are the Implications of Higher Taxes?* (link)

Comparing the Current Tax Law to the Proposed Changes

The following table compares the current tax environment to the proposals made by the House Ways and Means Committee, and President Biden's "Green Book".

House Ways and Means Tax Proposals[5]	Current Law[6]	President Biden's Tax Proposals (Green Book)[7]
Create a new 3% surtax on individuals with modified adjusted gross income (AGI) exceeding $5 million. Effective 1/1/2022.	This surtax does not exist in current law.	This proposal was not included in the President's plan.
Expand the net investment income tax (NIIT) to cover net investment income derived in the ordinary course of a trade or business for taxpayers with taxable income greater than $400,000 for single filers or $500,000 for joint filers, as well as for trusts and estates. Effective 1/1/2022.	Currently, the NIIT only covers passive investment income.	This proposal was not included in the President's plan.
Increase the top individual income tax bracket to 39.6%, making the top ordinary income tax rate 46.4% (including the 3.8% percent NIIT and 3% surtax proposal). This new top bracket would start at taxable income levels of $400,000 for single filers, $450,000 for joint filers and $12,500 for trusts and estates. Effective 1/1/2022.	The current top tax rate is 37% on taxable income over $523,600 for single filers and $628,300 for joint filers. This top rate is scheduled to return to the top rate of 39.6% on 1/1/2026.	The President's proposal would have the top rate kick in at $452,700 and $509,300 respectively (adjusted annually for inflation).
Increase the statutory capital gains rate to 25%, making the top capital gains rate 31.8% (including the 3.8% NIIT and 3% surtax proposal). Effective 9/13/2021, subject to a binding contract exception.	The current top statutory capital gains rate is 20%.	For individuals with income over $1 million, a tax rate of 39.6% would be applied to long-term capital gains. After adding the existing NIIT, the top rate would be 43.4%.

5 House Committee on Ways and Means, *Responsibly Funding Our Priorities*. (Link)
6 Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals*. (Link)
7 Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals*. (Link)

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House Ways and Means Tax Proposals	Current Law	President Biden's Tax Proposals (Green Book)
Increase holding period for long-term capital gain treatment for carried interest from three to five years. The current three-year holding period would continue to apply for real property trades or businesses and taxpayers with AGI less than $400,000. Effective 1/1/2022.	Income that flows to the general partner of a private investment fund, known as carried interest, is taxed at the lower capital gains rates. Three-year holding period requirement for long-term capital gain and loss for certain service-based partnership interests.	Tax as ordinary income a partner's share of income on an investment services partnership interest in an investment partnership, regardless of the character of the income at the partnership level, if the partner's taxable income exceeds $400,000.
Disallow excess business losses *i.e.*, net business deductions in excess of business income, for noncorporate taxpayers. The losses can be carried forward to subsequent tax years. Effective 1/1/2021.	To the extent that a business is not passive, or considered a hobby, excess losses are deductible against ordinary income.	This proposal was not included in the President's plan.
Limit the exclusion on qualified small business stock for taxpayers with AGI of $400,000 or more, or any estate or trust to the 50% baseline exclusion. The special 75% and 100% exclusion rates would not apply to these taxpayers. Effective 9/13/2021, subject to a binding contract exception.	Taxpayers can exclude some or all the gain on qualified small business stock held for more than five years. Percentage of exclusion is based on when the stock was acquired. Gain exclusion is limited to the greater of $10 million or 10x the basis on the stock.	This proposal was not included in the President's plan.
Cut the estate and gift tax lifetime exemption in half from the current inflation adjusted $10 million per person ($11.7 million in 2021) to an inflation adjusted $5 million. Effective 1/1/2022.	Current estate and gift tax exemption of an inflation adjusted $10 million ($11.7 million in 2021) is set to cut in 2026.	Treat transfers of appreciated property by gift or on death as a realization event; effective for gains on property transferred by gift, and on property owned at death by decedents dying after 12/31/2021.

House Ways and Means Tax Proposals	Current Law	President Biden's Tax Proposals (Green Book)
Transfers of non-business assets are not afforded a valuation discount for transfer tax purposes.	Transfers of assets are valued for transfer tax purposes at their "fair market value."	Though part of past proposals, not part of the current Green Book.
Require grantor trusts to be included in a decedent's taxable estate when the decedent is the deemed owner of the trust. Effective date of enactment. Assets transferred to a grantor trust prior to the effective date are grandfathered.	Even though a grantor trust is disregarded for income tax purposes, a grantor trust is not included in the grantor's estate.	This proposal was not included in the President's plan.
Impose new contribution limits and increase the minimum required distributions for high-income taxpayers when the total value of an individual's IRA and defined contribution retirement accounts generally exceed $10 million as of the end of the prior taxable year. Effective 12/31/2021.	Current limits on contributions are income based. Current RMDs are based on value of the IRA and the appropriate actuarial schedule.	This proposal was not included in the President's plan.
Eliminate Roth conversions for both IRAs and employer-sponsored plans for single filers with taxable income over $400,000 and joint filers with taxable income over $450,000.	A person can convert their eligible IRA assets to a Roth IRA regardless of income. Prior to 2010, only those account owners who had a modified adjusted gross income below $100,000 were eligible to convert.	This proposal was not included in the President's plan.
Deny charitable deductions for contributions of conservation easements by partnerships and pass-through entities if the deduction amount exceeds 2.5 times the sum of each partner's basis in the partnership that relates to the donated property. Effective 12/23/2016.	These arrangements often are referred to as syndicated conservation easements, which were previously identified by the IRS as listed transactions.	This proposal was not included in the President's plan.

Closing Thoughts

As always, we invite you to connect with your wealth advisor if you have any questions about the proposed changes in Washington D.C. or how they may impact your personalized tax strategy. Regardless of what comes next for markets, our team will be here to support your financial goals, both short and long-term.