The Hexagon Briefing: A Global Perspective from HSBC

Episode 7: How Tax Policy Can Impact Wealth Planning
June 23, 2021

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Jose Rasco

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Welcome to the Hexagon Briefing: A Global Perspective from HSBC. Each episode, we'll bring you our insights on key financial topics. You can learn more about insights and research offered by HSBC on our website at www.us.hsbc.com.

I'm your host, Jose Rasco, and thanks for joining us today.

Today, we're going to cover the topic of Changing Fundamentals in Wealth Planning. Carly Doshi, US HSBC Private Bank‘s Head of Wealth Planning and Advisory, is here to help me unpack that.

This podcast was recorded on Wednesday, June 23, 2021.

Thanks for joining me. And let's get going.

So one of the topics that we wanted to discuss today before we welcome our guest is the potential for higher taxes. Number one, why do we need them? And number two, what happens to the economy and the consumer in an environment where taxes, individual taxes, are going up?

So why do we need them? Obviously, we had a covid pandemic recession and then we had to sort of help lift the economy through stimulus. And some of that stimulus was on the monetary side with low interest rates, you know, a lot of printing of money. And part of the stimulus was, was fiscal spending, where the government increased the budget deficit. And as a result, we have to pay that bill. Part of that bill will get paid over the longer term, but part of it needs to be paid in the shorter term. And we need to get our budget on an annual basis, more in line with where it currently is and bring those budget deficits down. One way to do that is obviously to increase taxes, not just individual taxes, but corporate taxes. So the question de jure is do higher individual income tax rates kill the economy, put the economy in recession and how do they affect financial markets?

So obviously, we have seen tax rates move all over the place throughout our history. And more recently than not, we've seen them heading in a downward trajectory. So if we were to see taxes go up, what could that mean for the consumer? Now, the consumer historically, consumer spending is driven by a couple of factors. It's driven by the economy. It's driven by the labor market. It is driven by the unemployment rate. Is the unemployment rate going down? Unequivocally, it should be going down over the next 12 to 24 months. So as a result, that should be a real positive for consumer spending.

What about the savings rate currently due to all the fiscal stimulus and all the transfer payments to consumers? The consumer savings rate is at historically high levels, also bodes well for consumer spending. In addition, wages tend to affect consumer spending and wages are currently going up. And they're going up because we're having trouble hiring people, because the economy has opened up with such ferocity and there is so much pent up demand that many businesses are offering employment opportunities that are really creating a sense of competition in the labor market that is bidding up wages. So we have an improving economy, we have a lowering of the unemployment rate and we have improving wages. Those are all positive for consumer spending.

Now, what happens when taxes go up? Historically, when taxes go down, consumer spending increases more rapidly because you have more discretionary income. So you will see an acceleration in consumer spending when taxes go down. Now, when taxes go up, yes, consumer spending grows a little slower on the margin. It does not kill consumer spending. And if you look at history in the different periods where we have seen taxes go up, consumer spending has continued to rise at a very good clip in keeping with the economy. But it has definitely been a bit slower than in periods where the tax rates have decreased.

So on the margin, higher taxes will probably slow the consumer spending story a bit. But don't forget another big part of this consumer spending story and the consumer tax rate story is that taxes are going up for people who are at the upper end of the income strata. For people who are in the middle class or in the lower middle class, or who are doing worse than that in terms of income generation, there are a great deal of tax offsets or fully refundable offsets, which mean that even if you do pay tax, you could actually get a tax rebate from the IRS, which puts more cash in the consumer's pocket and as a result could help lift consumer spending for the middle class and lower middle class parts of society. So historically, taxes will affect what's going on in terms of consumer spending, but only on the margin. It's driven by the economy.

What do higher taxes do for the markets? Well, clearly, since many market participants, you have to have the discretionary income. It doesn't really in terms of the middle class and lower middle class, that's more a pension fund story. And so as a result, when we see income tax rates go up in terms of market activity, it is driven by the economy and profits. So that is still the story. And if you look at the sectors that do well after taxes go up, they tend to be very cyclical. So in other words, you see that when the economy is doing well, the market is doing well, and those sectors, such as consumer discretionary financials and materials, which tend to be procyclical sectors, tend to do well.

So I think the message here is if taxes go up for the consumer at the upper end of the income strata, yes, it will have an effect on the economy. And you could see certain pockets of consumer spending be affected, such as luxury sales, perhaps, but for the middle and lower income parts of the economy or segments of the economy where we will have those offsets, it's most probable that spending will continue to be driven by the unemployment rate, which is going lower, wages which are going higher, and an economy which still seems to be pretty healthy. So higher taxes an issue. Yes, but not the end of the economy and certainly not the end of what we see for financial markets, which should be a positive environment going forward.

Well, listen to the past year has thrown us a lot of curveballs. And what does it all mean for how we plan for the future? You know, between the covid pandemic, the covid recession, now the recovery, a new administration in Washington, a lot to talk about, a lot to think about in terms of planning for the future, not just in terms of investments, but your overall financial well-being.

To help me discuss all that today, I am pleased to tell you I am joined by Carly Doshi, who is US HSBC Private Bank‘s Head of Wealth Planning and Advisory. Carly, welcome to the Hexagon Briefing.

Carly Doshi Thank you Jose. A pleasure to be here.

Jose Rasco So, you know, look, Carly, you and I have known each other for a long time. We've done a lot of events together and clients have certainly heard us talk before. But I think what we want to do today is give like an update as to where we are in some of these, on some of these very important issues. If you look at what's happened over the past 18 months, let's call it, as I mentioned, covid the recession, the recovery and a new administration. A ton of money has been spent to try to help those who were most affected by covid. And we still have, you know, major pockets of the population that aren't back to work and that are still struggling with something as simple as rent, the ability to pay for their basic necessities. So there's all kinds of need out there, and yet there's all kinds of opportunity at the same time. So it's this perplexing period of great optimism with a dose of reality. And if you look at what the government has done and they've added to the monetary base dramatically, with M2 rising at more than 25%, they have increased the deficit. And if you look at the deficit numbers, they're somewhat impressive. Right? And have to be dealt with. And it had to happen because we had to provide that relief and then provide that stimulus to get the economy moving again. So clearly, this has to be paid for somehow.

If you look at the Biden administration's plans, both short term and long term, including infrastructure and a series of other issues. And if you look at infrastructure, President Biden has sort of strategically placed it in three different camps. One is physical, one is digital, and the other is social, where we have pockets of our population that need to be brought up to speed so they can, in fact, enjoy the fruits of the economy and get a job. And so all those spending plans together add up to about 9.4 trillion dollars, most of it spent in the next couple of years, but some of it over the next 8 but 9.4 trillion, which is about 45% of GDP, which actually exceeds what FDR spent on the New Deal, you know, in the Great Depression of the 1930s. So a lot of money being spent. And again, somebody's got to pay for it. So the potential for higher taxes is there. It's not baked into the cake. It's not a guarantee. But clearly, the signals from Washington are that we've got to pay the bills and somebodies taxes are going to have to go up.

So Carly, if you don't mind, I've given a bit of a backdrop as to what's going on with the macro picture. And we certainly have an economy that looks pretty healthy and an economy that's growing at a good clip. If you look at the corporate balance sheets, they are extremely healthy and profitability in the US could be up as much as 45% this year. And Bloomberg consensus estimates currently suggest to us that earnings could be up 20% over the next 2 years. It's about 10% a year roughly. And the consumer balance sheet looks very healthy with the savings rate sitting at almost 28% through March. So the economy looks good, but as taxes go up, we will talk about what effect that could have on the economy and more importantly for our clients, financial markets.

So the first issue on the table is individual income taxes. The Biden administration has talked about raising individual income taxes, but mostly for people who make more than $400,000, and then there is talk of taxing people who make more than a million, and there's different proposals out there. So we don't want to get lost in the minutia of Washington jockeying for position and trying to get the right package together. But clearly, taxes for those who make more than $400,000 are most probably going to go up.

Can you give us some perspective on that? And to be fair, Carly, to you, it's really early days and we know this is going to be bandied about and debated for the next 4 to 6 months before they come to an agreement on a budget. So can you tell us, you know, in terms of what you're seeing on the income tax side, just the potential outcomes? And how can clients begin to prepare for that if that does come to pass?

Carly Doshi

Absolutely. Thanks Jose. And look, I think you hit the nail on the head here, which is that the State of the Union is higher taxes. Right? That's what we know is the theme and the trend. And so if there's anything to take away from the conversation that we have today, what I would say to those listening is you need to be prepared for a higher tax environment and engaging in planning now so that you are best situated for when that comes to pass. From there, then we can go into details. But know that at the highest level, if there's nothing else to take away from this session, it really is that higher taxes are coming in one way, shape or form.

Now, as you said, the Biden administration has proposed trillions of new federal spending. Meanwhile, members of both houses of Congress, both in the House and Senate, have their own proposals, which would also increase taxes. And there that includes everything from increases in capital gains and corporate income taxes to individual tax credits, most of which do taper off or have limits for high earners. So they're really not applicable to high earners and high net worth individuals. But these are truly sweeping. And many of these proposals that we'll talk about today actually have conflicting provisions. So what ends up being the law of the land when when things come to pass? Very much unknown, very much TBD in the details. That's why I say the theme here and the direction that we're heading in higher taxes. That's really the take home

message today, right? The individual members are very much in flux and we don't know where they will shake out when when a bill is actually signed.
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Jose Rasco

And you touched on an interesting point which may not fit in the planning side. Right? But it is an interesting development perhaps on the investment side. So President Biden is talking about providing relief to middle income and lower middle income families through the child tax credits and a series of other provisions that can actually reduce their taxable base or actually provide fully refundable tax credits, which means no matter what you pay in taxes, you could get a rebate from the IRS at the end of the year if you fall into those income categories. So now that has an effect and again, it may not be a planning issue for the clients, but from the investment perspective, does that mean that the retail story, the procyclical consumer discretionary story, continues to be in favor? Because as those pockets of the population that need relief, get relief, we could see a bigger bounce in the consumer and that pent up demand could continue to grow. So it's something that to your point earlier, it's not just about, you know, planning. There's other pockets to this and other aspects of the calibrated.

Carly Doshi

Absolutely, absolutely. And it's a good question, right? I mean, I think that's ultimately at least as the Biden administration has discussed, it is one of their fundamental goals of enacting this tax policy in the first place.

Jose Rasco

Right, exactly. So clearly, income taxes going up most probably for high income earners. And there are many tools. Now we don't want we can't get into specifics with you on this call, folks, because obviously it's an individual issue. And so to sit here, if Carly were to talk about my personal situation may not be applicable to the person listening. So there's really no point in doing it. But the point is, you need to reach out to start planning on the individual side.
Now, the other one of the other changes, Carly, is has been the talk around capital gains. And so if capital gains get raised to the level of ordinary income or the marginal highest marginal income tax rate, on the personal side, that would be more than a doubling of the capital gains tax. And what we've seen in the past is that that can, in fact, affect investment spending on the corporate side. But it's not the kind of thing that's happened all that often. So we don't have all that many data points to base it on. But the rhetoric, the talk is that companies would therefore make decisions.

What about capital gains in terms of the individual investor? What could be some of the ramifications in terms of the markets from your perspective from as a planner, what could happen before year end if we see that capital gains tax going up?

Carly Doshi

Absolutely. So on the capital gains side, and this is actually one of, I think, the more interesting proposals that have been pushed out there, it's definitely received a lot of airtime for the reasons that you just suggested, because there's massive implications for investments and potentially markets. But it's also really interesting for those of us who follow tax policy, because it's quite unique and I should say potentially very complex to functionally administer, which which has its own implications for whether or not this is even realistic. But let me first back up a second and explain what's what's kind of on the table here, because there's a couple of things going on.

So in Biden's plan and again, remember, I mentioned that there's the administration has its plan and proposals dating back to the campaign, as well as more recent proposals, as well as the Treasury came up with its Green Book of revenue proposals for the year for 2022. So we've got a lot of different plans going on. But in Biden's, American Families Plan Act – that's the plan from Biden and that one would tax long term capital gains and dividends as ordinary income for taxpayers with taxable income above $1 million. That's what that's what you mentioned already, right? It would also limit 1031 exchanges by eliminating the deferral of gains above $500k. So that's another interesting proposal.

Now you asked what does that mean in terms of strategies and what are people going to do about that? Well, what we might see is, we might see an increased realization of gains in anticipation of that for people who are above that taxable income threshold of $1 million as people generate their needed liquidity now, before it's taxed at that higher ordinary income rate, right? I don't know if that –

Jose Rasco Is that what's known as forced selling? It's the euphemism for it, is that –

Carly Doshi Yeah, and look, to be clear, I don't know how widespread activity like that will be. Right? As you already said, this is really a question for individuals, investors to consider with their teams. I would implore everyone listening today to to consider this sort of an all hands meeting. And you need to have a conversation with your investment professionals as well as your tax and legal providers, because there's implications on both sides there. Right? You need to weigh both the investment implications of such a decision if you are actually going to liquidate some assets or to to realize some capital gains. And then you also need to to weigh that against any potential tax benefit. So it's a very individualized analysis. It is not a one size fits all approach, but it is something that we could see. Right. And that could trigger greater liquidity as people take action like that in anticipation of those capital gains rates going up.

But there's another piece of this capital gains puzzle that I think is really interesting. And again, for people listening, a lot of this this jargon is thrown around and you're hearing a lot of it, capital gains, capital gains. There's also this concept, capital gains in the inheritance context. And it's it's a bit different than the federal estate tax exemption, which we can talk about. But really, it's a capital gains question and that is this proposal to tax capital gains at death. Right? Now that proposal is included in both the White House's plan as well as the Senate's Step Act bill, which is a bill that was sponsored by many of the same senators as the Wealth Tax Act. So it includes Bernie Sanders, Elizabeth Warren and others. And that one would actually be retroactive to January 1, 2021 one if it was passed in its current bill form. Again, we don't know if it does pass at all what the provisions will look like. Things such as the date of effectiveness could very well change. But as it was proposed, it's retroactive to January 1, 2021.

And what both the White House bill as well as the Senate version do is that they propose to realize gain death with a $1 million exemption, and that means that any amount above $1 million that a person has at death would be taxed as a realized capital gain event. That is a very different system than we currently have in place today. The White House version specifically doubles it to $2 million for joint filers, and the Senate version provides 15 years for deferral period. But keep in mind that there would be a lot that would have to occur during that period, because, as we know, most wealth in this country is held in illiquid form. Whether that's in operating businesses, real estate or other illiquid investments. So the idea that there could be a tax imposed right and that something was deemed as is a realized gain at death, very, very different than something that we've seen before with lots of implications. And I can tell you, lots of tax policy wonks are out there spending many, many hours trying to figure out exactly how this would function if it were to pass, because it is so unique and different. But it's a capital gains tax at death, different than than actually changing the capital gains rate for people who are alive, but nonetheless, something that sort of has this capital gain like flavor to it.

Jose Rasco All right. So we clearly want to is the old maxim says work your plan and plan your work. And so we really need to plan. I'm getting that message. Second, message is from the investment side of taxes go up. There are certainly certain instruments you can deploy in your asset allocation.

Now, on the capital gains side, there's there's a lot of talk about the dividend tax not moving up or the tax on realized dividends moving up. So we could potentially see a shift in the market to some dividend payment strategies that might mitigate tax consequences for wealthy investors. So that's something that's out there.

Now, you touched on inheritance, so let's move right to that. What's going on? And let's go to an easy topic, Carly. Let's go to inheritance taxes. And again, not going to hold you to it because I know it's moving all over the place. And by the time this gets enacted, it's probably going to look very different. But what do you seeing in terms of inheritance taxes? And again, I know the message is going to be you better start planning now for the future, but give us some of the details and some of the minutia that you're seeing out there that you think could be of consequence, please?

Carly Doshi

Absolutely so thank you. And I love starting with the punch line first the which is, of course, get to planning now if you haven't already. Look, inheritance and estate tax, this is something that you and I have been talking about for a long time. Certainly during the election, there was a lot of discussion about this. And and the message is the same, which is that we know the direction that things are heading in and we know that you need to engage in planning now, if you haven't already, now is the time.

But let me step back for just a second. Recall that prior to 2018, the federal estate tax exemption was 5 million and that was adjusted for inflation. So that, practically speaking, married couples had roughly 11 million dollars exempt from federal estate tax, which with which they could pass on their wealth to their heirs or people of their choosing. The Tax Cuts and Jobs Act of 2017 that doubled the exemption amount, meaning that each single person had roughly 11 to 11.5 million adjusted for inflation, and married couples had 23 million. Now. And now both before the Tax Cuts and Jobs Act, as well as under current law, the tax rate is 40%. 40.
Now, during the presidential campaign, Biden called for the federal estate tax exemption to return to the historical norm. And while specifics weren't really outlined in what that meant. Historical norm is basically widely understood that that means the 2009 exemption of 3.5 million and a rate of 45%. So bringing that exemption amount down and the rateup. Since then, we do have more more developments. The administration, though, their focus is really more on that capital gains realization at death proposal that we already discussed. That's what's in the Biden administration, American Families Plan Act. And in addition, when the Treasury Department released its fiscal year, 2022 revenue proposals, which is commonly referred to as the Green Book, the Biden administration did not include estate and gift tax proposals either those discussed during the campaign or even those proposed back during the Obama administration.

What does exist, though, is that there are 2 congressional bills, 1 of which is sort of colloquially known as the Bernie Sanders plan, the the for the 99.5% tax plan. And the other is the American Housing and Economic Mobility Act, which is sponsored by Elizabeth Warren and others. And both of those do propose lowering the federal estate tax exemption to 3.5 million and imposing higher tax rates. The rates are a bit different. Both of them have a graduated schedule that begins at either 45% or 55% and top out at 65%. The Warren plan actually imposes an additional 10% surtax for estates over $1 billion in size. But the theme there is that the congressional bills both would look to bring down the exemption amount, meaning that less can be passed on at death, free of tax and also increasing that tax rate. However, we don't see that in the Treasury proposal, so it doesn't seem like the Biden administration has that on its priority list, at least for the moment. But it could be simply that the administration is choosing to focus instead at the moment on that capital gains tax at death that we already talked about.

Jose Rasco

All right, Carly, thank you. So so and keep in mind, folks, we're talking about raising individual income taxes, inheritance taxes, capital gains. Again, presupposing some of this stuff going can actually get passed into law. Now, what history tells you is when taxes go up, it will affect consumer spending on the margin. But the really important variable is that this is happening at the beginning of a business cycle, which means the unemployment rate is going down, which is good news. That is going to most probably have more of an effect on the economy than the increased tax rates.

And secondly, we're at the beginning of a multi-year rollout of these technology issues and new technologies that are going to be very productivity enhancing and profitability creating. So as a result, even though taxes are going up, we still remain positive because we don't see this being an overall drag on the system to the point where it's the goose, we kill the goose that laid the golden egg. The economy continues to advance. Markets should still do well. But yes, it will have an effect on the margin.

Now, Carly, let's switch gears for a second, if you don't mind, on the corporate tax side. Now, we've done some work on this. And when corporate taxes go up, yes, that could have an effect on corporate investment spending, but corporate investment spending is really more driven by cash flows than by tax policy. Tax policy can be mitigated by companies, number one. Number two, correct me if I'm wrong, but the Biden administration is offering a tremendous amount of offsets so that companies will continue to invest. So even though the corporate tax is slated to go up in many proposals, it could be that we see some of these offsets mitigate some of that negative effect that could occur in terms of investment spending. Is that what you're seeing still?

Carly Doshi

That's right, Jose. And so what we've been talking about so far have been some proposals by the Biden administration and by both houses of Congress that really focus on individual tax. There is another whole body of proposed legislation that would impact corporate income tax rates, as well as some corporate incentives that you already mentioned. The provisions are lengthy and the details are many because we're really talking about a variety of proposed legislation, everything from and many of these have these acronyms that we know Congress loves to tack on to their their bills, so we've got the Align Act, the Forward Act, the Facilitating American Built Semiconductors Act, which is specifically for investments in semiconductor manufacturing equipment, we've got the Create Jobs Act, they're very, very lengthy.

But let me mention just a couple of things. For example, the Tax Excessive CEO Pay Act would increase the corporate tax rate that a company pays based upon the ratio of their CEO's pay to the pay of the median worker. That's just one example of the way that Washington seems to be approaching these things and looking at ultimately what the rhetoric that's out there, of course, is looking to reduce the wealth gap, to shift taxes so that corporates are paying more and low and middle income individual taxpayers are paying less. I would say that's the overall theme. It continues to be the theme across both individual tax and the corporate tax proposal space.

Jose Rasco

So corporate taxes going up as well, trying to mitigate some of the effect and trying to lessen the burden on the consumer. So let's see how this all plays out in terms of the dynamics.

Now, one of the things that we've been very focused on, Carly, is obviously the infrastructure focus on this technology rollout and many themes have been focused on that from our bank. Now, as we move forward, this is very much intertwined with sustainability and the desire by the administration, as well as many investors around the world to invest more on a regular basis and to incorporate sustainability into their day to day investment decisions. Right. It shouldn't be something set aside, shouldn't be something in the background. It's going to become more and more ingrained in our day to day investment and planning decisions. So as part of that, this all fits in where they're trying to use some of those revenues and and some of those tax offsets to help encourage more sustainability issues. But as we go forward, another way to do this is through philanthropy. And a lot of our clients are involved in philanthropy.

Would you like to touch on some of the issues or some of the areas where you could see some shift in the philanthropy landscape and how clients might begin to have that conversation with you, as well as some of their legal advisers?

Carly Doshi

Absolutely, Jose. So, look, we just talked a lot about taxes going up, and that is, to be sure, the theme of the day. Right. But one area that even when the Tax Cuts and Jobs Act was passed and many of the individual tax deductions were reduced or eliminated, the charitable deduction was preserved. And in fact, we've seen an expansion of the charitable deduction during covid for tax years for 2020 and 2021 to a potential 100% AGI limit, effectively 100% charitable deduction available to taxpayers who give generously during this time. And that really reflects Washington's understanding that private philanthropy, private charity really isn't a very effective means at achieving some of their goals of bringing up the hardest hit individuals and families in the country. So that said, charity absolutely remains an effective strategy, both for employing and your personal views and and your values.

But also there are some interesting tax plays there, too, because, of course, you can receive a charitable deduction this year through December 31, we do have that available 100%, which means that should some of these other proposals we've discussed, co me to pass and you find that you're impacted by them, if anything is retroactive to 2021, then potentially one strategy could be to mitigate some of that increased tax burden by making a corresponding increase charitable gift and receiving a deduction. That's kind of the most straightforward way to think about this.

But the theme overall of charitable planning really being a core part of this overall charitable planning, being a core part of the overall covid relief plan, if you will, because of both the Trump administration and the Biden administration's dedication to preserving and even expanding that charitable deduction, I think really bodes well for charitable giving. And I absolutely think that for people who are concerned about their taxes on a going forward basis, you should absolutely be thinking about whether or not including charitable giving in your strategy makes sense.

Jose Rasco Carly, well wow, a lot to ponder right now. An economy that's expanding a multi-year rollout of technology that should enhance productivity and profitability, changing tax policy. Now, clearly, I hope you I hope you guys enjoyed the conversation with Carly today. And I think the key takeaway is begin to plan, begin that conversation with your legal tax planning advisers as well as your investment advisers, whether they're at HSBC or otherwise. And we are here for you. Either way, I think the key takeaway is, you know, the concept of higher taxes always sounds like this ominous thing on the horizon. The good news, I guess we can get out of this, while no one wants to pay higher taxes necessarily, obviously, the good news is it seems like the money has been put to good work and trying to get us out of covid. Number two, it's being put to good work in the sense of trying to build a sustainable future for the US economy. And if you want to try to mitigate some of those tax consequences and at the same time do some good, there is lots of opportunity out there. So from the investment and planning perspectives, lots of conversations to be had during the summer. And as we head into the fall, Carly, I hope you'll accept our invitation to come back and have a more detailed conversation on the actual proposals where the rubber is going to meet the road and our investors are actually going to be affected when Washington comes to a consensus. So I hope you'll join us again.

Carly Doshi Absolutely. It would be my pleasure. Thanks, Jose.

Jose Rasco All right, guys. Thank you, everyone. And so a lot to ponder on the individual side in terms of cap gains, individual taxes, as well as the corporate side and what's going on with the tax regimes out there. And how can that affect your investment decisions? As Carly mentioned numerous times, reach out to us and we're here to help. Thanks, everyone. Thanks for listening to the Hexagon Briefing. I'm Jose Rasco. See you next time.

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