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President Joe Biden Tax Plans – The Impact on Individuals

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Background. Last week, on April 28, 2021, Biden released his proposed **American Families Plan**, which could dramatically change the U.S. taxation for individuals. This is of importance for Israeli residents who are U.S. citizens (or hold a green card), U.S. residents that plan on relocating to Israel and Israeli residents who plan on relocating to the U.S.

The Proposed Measures. While the proposals lack full details on how the provisions would be implemented, the following is an overview of what they would provide:

- Increasing the maximum individual federal income tax rate from 37% to 39.6%.
- Increasing the maximum federal tax on capital gains from 20% to 39.9% for taxpayers with incomes over $1 million. (Combined with the net investment income tax of 3.8%, this increase would result in federal taxes of 43.4% on capital gains).
- Increasing the individual tax for fund managers on 'carried interest' allocations. Under the proposal, the "President is also calling on Congress to close the carried interest loophole so that hedge fund partners will pay ordinary income rates on their income just like every other worker." Depending on this would be implemented, this could suggest an increase to a maximum rate of 39.6% or possibly 43.4% (if the net investment income tax is added).
- Eliminating the step-up in basis on death for gains in excess of $1 million ($2.5 million per couple "when combined with existing real estate exemptions"). There would be protections for family-owned businesses and farms when transferred to heirs who continue to run the business.
- Limiting the amount of gain to $500K that may be rolled-over in an exchange of like-kind real estate.
- Permanently extending the current limitation on large, excess business losses.
- Imposing the 3.8% Medicare tax on earnings of taxpayers making more than $400,000.
- Requiring financial institutions to report information on account flows so that earnings from investments and business activities are subject to reporting more like wages.
- Increasing the resources available to the Internal Revenue Service to effectively enforce the tax laws against taxpayers with the highest income.

Israeli Residents with U.S. Citizenship. The Biden proposals, if enacted, could have a material impact for any individual subject to the U.S. tax rules, including Israeli residents. Here are a few points to consider.

- **Capital Gain**. Israeli residents who are also U.S. citizens are subject to tax by both countries and are effectively required to pay the higher of two rates. Historically, where the maximum U.S. long term capital gain rate (20%) has been lower than the maximum Israeli rate on gains (33% for a material shareholder), the tax cost of an exit has focused on the Israeli tax impact. However, if this proposal were enacted, an Israeli founder with U.S. citizenship could face a marginal rate of 39.6% (plus the 3.8% for the net investment income tax) in the event of a successful exit.
- **Fund Managers**. Under current law, Israeli Fund managers with U.S. citizenship face a potential exposure of ordinary tax rates on their carried interest gains, if a 3-year holding period isn't satisfied. However, under this proposal, it appears that all carried interest allocations may become subject to ordinary tax rates, which would put them at a significant tax disadvantage over their colleagues who are not U.S. citizens.
- **Stock Options**. Israelis with U.S. citizenship also face disparate tax treatment with respect to stock options – the extent of which is beyond the scope of this alert. However, in the simplest case of Section 102 options that are held until a liquidity event, the optionholder who is a U.S. citizen would generally be required to pay additional U.S. tax above the Israeli tax of 25% withheld by the 102 Trustee. Under U.S. tax rules, however, the cash out would be subject to marginal ordinary rate (with a credit for the amount of the Israeli tax paid). Therefore, the increase of the U.S. maximum rates from 37% to 39.6% under this proposal would increase such additional tax liability.

Israeli Residents with U.S. Investments. Israelis investing in the U.S. may also face and increased tax burden.

- **U.S. Real Estate**. Israelis (who are not U.S. citizens) who invest in U.S real estate have historically anticipated that the maximum U.S. federal tax (20%) would be lower than the maximum Israeli tax, with the result that the investment would not be subject to a higher tax cost than another investment. An increase of the maximum capital gain tax to 39.6% for U.S. source gains over $1M (such as U.S. real estate projects) could have adverse tax consequences to the Israeli investor.

Israeli Residents Relocating to the United States. Israeli residents who relocate to the United States and become U.S. residents generally become subject to U.S. federal (and state) taxation on their worldwide income. However, certain gains, such as gains for a founder on the sale of founder shares or the cash-out of Section 102 options that vested before such person relocated, may still be subject to Israeli tax, even if realized after relocation. While these scenarios have historically raised many tax complexities and uncertainty, the Biden proposals magnify some of these issues:

- **Gain on Exit**. An Israeli founder who has relocated to the United States faces in many situations the risk of double taxation due to the imposition of the Israeli exit tax. However, in certain situations the founder may be eligible to claim a credit against his U.S. federal tax liability in the United States for the Israeli tax that may be due on such exit. Yet, if the exit generates gain in excess of $1M, under this proposal a portion of such gain would be subject to federal tax at the maximum rate of 39.6%, which would be significantly higher than the rate of the Israeli tax that would have been imposed had he never relocated.
- **Options**. As described above, U.S. tax law imposes marginal ordinary tax rates on the cash-out of options. Israelis who have been granted Section 102 options may have previously anticipated such options would be subject to only Israeli tax of 25%. However, if they relocate to the United States and the options are subsequently cashed out, the gains would be subject to marginal rates. Under this proposal, with the increase of the maximum rate to 39.6%, the disparity between anticipated tax and actual tax would be greater.

The Take Away. The Biden proposals may have a profound impact that should be carefully considered. Particularly, Israelis who currently reside in the U.S. considering relocating back to Israel and Israelis considering to relocate to the U.S. should carefully consider how these potential changes could affect their plans and their timing. There is real opportunity to reduce the overall tax burden upon relocation provided that planning and implementation takes place before relocation.

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