HIGHTOWER
Financial Principles, LLC

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THE POTENTIAL IMPACT ON MARKETS AND YOUR FINANCIAL PLAN

Complex, uncertain, confusing, and tense are all adjectives that come to mind when describing a year marked by a global pandemic that put the brakes on global economic growth and stoked market volatility as a national discussion over racial injustices has taken center stage in the media. While short-term, and long-term, economic impacts of these events are still an unknown, the November Presidential Election stands to only add to uncertainty and the complexity of effective tax and estate planning.

Before diving into the potential impact of the election on markets, taxes, and financial plans, let's take stock of the House, Senate, and Presidency, and some potential scenarios for a change in control of the government. *Please do keep in mind that this entire analysis is apolitical, and we do not favor any candidate or intend to in any way influence your vote. We only intend to compare potential outcomes and assist in thoughtful planning to strengthen clients' financial plans regardless of the election results.*

The Senate

Republicans control the Senate with 53 seats compared to the Democrats' 47 seats. Democrats need to pick up 4 seats to gain control. Democrats have 12 seats up for reelection while Republicans are defending 23 seats.

The Presidency

The Presidency is currently held by Republicans. With the Presidential election just getting into full swing, President Trump appears to have an uphill battle to hold on to the White House as polls show a widening margin favoring former Vice President Biden.

The House of Representatives

Democrats control the House with 232 seats to Republicans' 198. There is one seat held by a Libertarian and there are currently four vacancies (three of which are retiring Republicans). Republicans need a net gain of 20 seats to take control and there are 25 seats viewed as "toss-ups" that are up for grabs.

FOCUSED ON YOUR FINANCIAL INDEPENDENCE

WHO IS GOING TO CONTROL CONGRESS AND THE WHITE HOUSE?

As of the writing of this piece, consensus polls indicate that the race for control of the Senate is in a dead heat and literally up for grabs while the House of Representatives is more likely to remain in control of the Democrats. In the House, Democrats need only secure 4 of the 31 "toss-up" seats that are up for grabs to retain control.

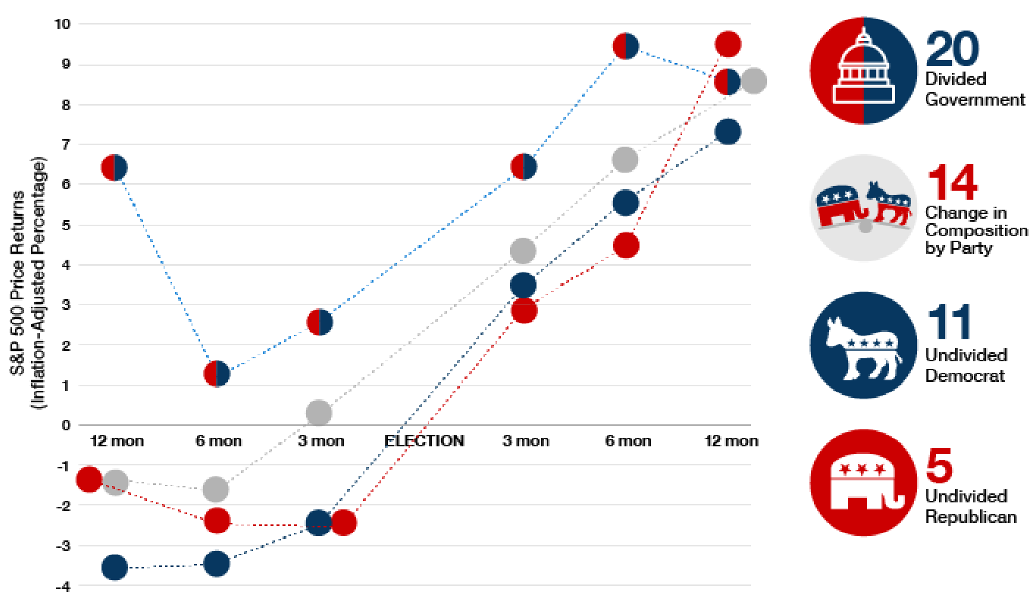
On the Presidential front, despite consensus polls favoring former Vice President Joe Biden, the first candidate to secure 270 votes of the Electoral College will win the presidency. The winners of many states' electoral votes are all but decided well before the election due to the political leanings of many states. Consensus indicates that Joe Biden has the firm support of 232 electoral votes, while incumbent President Trump has 204. Six battleground states will likely determine the election—those being Florida (29), Pennsylvania (20), Michigan (16), North Carolina (15), Arizona (11), and Wisconsin (10).

Florida is a critical state for both President Trump and former Vice President Biden. If Trump secures Florida it will be a scramble for the remaining five states in the race to 270. On the other hand, if Biden takes Florida, Trump would need to sweep all five remaining states to win. While President Trump may appear to have an uphill climb, especially in light of a widening margin in polls for Biden, the electoral map is eerily reminiscent of 2016 where Hillary Clinton secured 232 electoral votes and President Trump (the underdog candidate) swept all six of these same battleground states.

In short, the House of Representatives may likely remain in control of the Democrats while the Senate and Presidency are up for grabs.

Historical data tells us that markets don't care whether there is a Republican or Democrat in the White House. The markets also don't care who controls Congress. But what the data does show us is that markets do not like uncertainty. In the time leading up to elections, there are generally more muted returns while markets tend to move higher after elections are passed.

MARKET RETURNS BEFORE AND AFTER ELECTIONS



Real (inflation-adjusted) S&P 500 price returns are inconclusive when it comes to measuring election impact.

With that all said, this election cycle can very well bring unwanted volatility to equity markets in the coming approximately six weeks as it plays out.

A COMPARISON OF CURRENT PROPOSALS

With the federal deficit and national debt growing, whoever wins the Presidency will ultimately be tasked with a combination of reigning in spending and raising revenues. The inevitable raising of taxes seems a foregone conclusion, with the question marks being whose taxes will rise, when, and by how much. Biden's proposal increases taxes to raise revenue while as of the writing of this piece, there have been no formal Republican proposals to address the deficit. Below, we compare the current tax laws passed in the Tax Cuts and Jobs Act under President Trump (and a handful of vague ideas and bullet-points about various tax cuts to pursue if reelected) with the proposals laid out by Joe Biden.

Area of Impact	Current Law	Biden Proposal
Long-Term Capital Gains and Dividends Tax Rate	20% (plus 3.8% net investment tax on applicable filers)	39.6% on taxable income over $1 million (plus 3.8% net investment tax on applicable filers)
Individual Ordinary Income Tax Rates	37% top bracket	Revert to a top tax bracket of 39.6% on taxable incomes over $400,000
Itemized Deductions	Eliminates the Pease limitation on deductions (a cap on certain itemized deductions for taxpayers with income over certain thresholds) through 2025 and limits State and Local Tax deduction (SALT) to $10,000	Cap value of itemized deductions at 28% (those in a tax bracket over 28% would face limits on deductions), restore Pease limitations on itemized deductions for those with incomes over $400,000, no current plan to restore full SALT deduction for those who could take advantage without a reduction due to Pease limits
Corporate Tax Rate	21%	28% and create a minimum tax for corporations with book profits greater than $100,000,000
Small Business Tax Rate	37% top bracket and a 20% deduction for qualified business income (QBI)	39.6% top bracket and phases out 20% QBI deduction for taxable income over $400,000
Payroll Taxes	12.4% on taxable income up to $137,700, indexed for inflation	Would expand to include all taxable income over $400,000 (creating a donut hole for income between $137,701 and $400,000)
Tax Basis Step Up	Step up basis at death	Eliminates step up in basis at death and replaces it with carryover basis and a possible "deemed" sale at death
Estate and Gift Tax Exemption	$11.58 million/individual; $23.16 million/couple	$1-$5 million/individual; $2-$10 million/couple
Estate Tax Rates	40% of value over exemption	40%-80% of value over exemption
1031 ("like-kind') Exchanges	Deferral of capital gains upon sale of investment real estate if proceeds are reinvested in other like-kind property	Would eliminate like-kind exchanges for taxpayers with annual taxable income over $400,000
Other items lacking detailed information	A "Made in America" tax credit, an expansion of Opportunity Zones, and various tax cuts including payroll taxes *(these items are not current law but are proposed by President Trump)*	An $8,000 tax credit for childcare, equalizing retirement plan benefits, eliminate real estate tax loopholes, expand ACA's premium tax credit, and sanctions on tax havens

Considerations to Watch and Planning Opportunities

While crafting a comprehensive financial plan that considers your goals, objectives, and risk tolerance is an important first step on the road to your financial independence, monitoring progress and adjusting (when necessary) that plan is critical. To the point of adjusting, in these uncertain times and with potential tax hikes on the horizon there are several planning considerations that can potentially save you money, taxes, and complexity down the road.

Acceleration of Income, Delay of Expenses- With income tax rates potentially increasing as early as next year, you may want to consider the acceleration of income to this year and even the delaying of expenses to next. By doing so, you will have realized income at potentially lower rates this year, while having more expenses to reduce income when rates may be higher.

Consider a Roth IRA Conversion- In a traditional IRA, assets grow tax-deferred until retirement, at which time all withdrawals are taxed as ordinary income. With a Roth IRA, you pay taxes up front in exchange for future growth being withdrawn tax-free in retirement. Paying taxes now, while rates are lower, could potentially shield these assets from higher future tax rates.

Consider "Harvesting" Gains- Each year we review clients' portfolios several times to harvest losses to reduce capital gains. As strange as this sounds, selling appreciated stock, paying the tax, and reinvesting in those shares may be advisable depending on the outcome of the election. For high wage earners, Biden's tax plan could nearly double the capital gains rate. For retirees thinking about wealth transfer, Biden's plan could eliminate the "step-up" in basis when inheriting assets so if your heirs are high wage earners and you are in a lower tax bracket, it may make sense as part of your estate planning to realize capital gains rather than leave them to your heirs. *Note: We have always advocated donating appreciated stock, rather than cash, to charity. A change to capital gains taxes would make this an even more valuable strategy!*

Consider Gifting Assets to Heirs, even in Trust- Biden's tax plan could lower the estate and gift tax exemption from $11.58million ($23.16million for couples) to $1-5million ($2-10million for couples) while raising the estate tax rate for assets above the exemption from 40% to as high as 80%. A potential reduction in the estate and gift tax exemption may make transfers of wealth and the use of Irrevocable Life Insurance Trusts to hold life insurance policies more important considerations for meaningful tax savings.

Business Owners Should Review their Business Entity Structure- Deciding not to convert your business entity from a pass-through entity such as an LLC or partnership to a C corporation may be advisable to guard against increased tax exposure. Likewise, revoking a C corporation status may be advisable, depending on your overall goals.

These times are challenging, and the election is adding a layer of complexity and uncertainty due to the wide range of possible outcomes that will affect your financial plan. No matter the outcome, calculated decisions will have to be made on how to manage the tax and estate planning impact of the election. We are happy to have a conversation to help ensure that your plan is in order. As always, if you have any questions, please do not hesitate to contact our team. Please be safe and stay well.

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Data sources:

Chart on Page 2: Lord Abbett analysis of Bloomberg data 1948 through November 2017

Tax Foundation, Details and Analysis of Former Vice President Biden's Tax Proposal, April 2020.

RealClearPolitics.com

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