Biden's Tax Proposal and Potential Impact on Executive Compensation and Stock Ownership

Democratic Party presidential nominee and former Vice President Joe Biden has proposed changes to current U.S. tax law that, if enacted, would significantly alter the status quo. The key aspects of Mr. Biden's tax proposal would (1) reverse President Trump's tax cuts, (2) impose Social Security taxes on wages over $400,000, (3) subject capital gains to ordinary income tax rates for high earners and (4) increase corporate tax rates.

Although the tax proposal is not directly aimed at executive compensation, it could still have a meaningful effect on the design of executive compensation programs.

Select Features of Mr. Biden's Tax Proposal

Outlined below are select features of Mr. Biden's tax proposal.

- **Increase corporate tax rate**. The corporate income tax rate would increase from 21% to 28%.
- **Roll back brackets for high earners and increase top marginal rate to 39.6%**. Taxable income over $400,000 would be subject to a top marginal tax rate of 39.6%. The Biden tax proposal does not indicate whether this tax bracket would apply to single or joint filers. Under current law, the top marginal tax rate of 37% is applied to income in excess of $622,051 (indexed) for joint filers.
- **Increase Social Security wage base for high earners**. The Social Security wage base would expand to cover wages in excess of $400,000, with no cap. The current Social Security wage base of $137,700 (indexed to inflation) would remain intact, with a Social Security tax rate of 6.2%. Mr. Biden proposes to impose the same Social Security tax rate on wages in excess of $400,000. Similarly, the Social Security wage base would expand to cover self-employment income in excess of $400,000, with no cap.
- **Increase corporate payroll tax**. Corporate payroll tax would increase to reflect the expansion of the Social Security wage base. Companies would be required to match employee paid Social Security tax on wages in excess of $400,000.
- **Increase capital gains tax rate for high earners**. For taxpayers with taxable income in excess of $1,000,000, the tax rate for long-term capital gains would increase from 20.0% to equal the top marginal income tax rate of 39.6%. Under current law, long-term capital gains are also subject to a 3.8% additional net investment income tax for joint filers with modified adjusted gross income exceeding $250,000. The Biden tax proposal does not indicate whether the net investment income tax would continue to apply to long-term capital gains or whether the $1,000,000 income level would be applicable to single and/or joint filers.

- **Overhaul tax preferences on 401(k) plans**. The deduction for employee contributions to 401(k) plans would be eliminated and replaced with a flat tax credit for each dollar saved. The Biden campaign has not indicated the level of the tax credit; however, the Tax Foundation has estimated that a tax credit of 26% would be revenue neutral. At that level, a taxpayer would receive a tax credit of 26 cents for each dollar saved, regardless of the taxpayer's tax bracket.

As shown in the table below, Biden's proposed tax policy would increase the top marginal tax rate (the rate applied to the last dollar of taxable income) to 48.15% from 39.35% under current law, representing a 22% increase.

Table 1: Comparison of Top Marginal Tax Rates under Biden's Tax Proposal and Current Law

	Biden Tax Proposal		Current Law	
Tax	**Proposed Tax Rate**	**Applicable Income/Wage Level**	**Tax Rate**	**Applicable Income/Wage Level**
Top Marginal Income Tax Rate	39.60%	Income in Excess of $400,000	37.00%	Income in Excess of $622,050
Medicare Tax Rate	1.45%	All wages, without cap	1.45%	All wages, without cap
Additional Medicare Tax Rate	0.90%	Wages in Excess of $250,000	0.90%	Wages in Excess of $250,000
Social Security Tax Rate*	6.20%	Wages in Excess of $400,000	0.00%	N/A
Combined Top Marginal Tax Rate	**48.15%**		**39.35%**	

*Under current law and Biden's tax proposal, Social Security tax would continue to be imposed on wages up to the current Social Security wage base of $137,700 (indexed). The Biden tax proposal would also impose Social Security tax on wages in excess of $400,000.

Effect of Biden's Tax Proposal on Wages and Capital Gains

For illustrative purposes, we examined the effect of Mr. Biden's tax proposal on a hypothetical senior executive with taxable wages of $2,000,000 and a $500,000 long-term capital gain on the sale of company stock (both for the same tax year). Mr. Biden's tax proposal would increase the executive's total tax liability to $876,118 from $730,436 under current law, *assuming the executive is a joint filer*.

Table 2: Comparison of Taxation of Executive Wages and Capital Gains under Biden's Tax Proposal and Current Law[1]

	Biden Tax Proposal		Current Law	
Tax	**Applicable Executive Wages/LTCG**	**Tax Liability**	**Applicable Executive Wages/LTCG**	**Tax Liability**
Individual Income Tax (assumed joint filer)	$2,000,000	$723,631	$2,000,000	$677,149
Medicare Tax (1.45% on all wages)	$2,000,000	$29,000	$2,000,000	$29,000
Additional Medicare Tax (0.9% on wages in excess of $250,000)	$1,750,000	$15,750	$1,750,000	$15,750
Social Security Tax (6.20% first $137,700 of wages)	$137,700	$8,537	$137,700	$8,537
Social Security Tax (6.20% on wages in excess of $400,000)	$1,600,000	$99,200	$0	$0
Total Individual Income Tax and Payroll Tax Liability		**$876,118**		**$730,436**
Long-Term Capital Gain (LTCG)	$500,000	$198,000	$500,000	$119,000
Total Tax Liability (including LTCG tax liability)		**$1,074,118**		**$849,436**

[1]This table was developed using the following assumptions: (i) Biden tax proposal does not alter the tax brackets and related tax rates currently in effect for taxable income at or below $400,000, (ii) the Biden tax proposal does not indicate the size of the standard deduction that would be available to taxpayers; therefore our analysis does not take into account the standard deduction available under current law (i.e., $24,800 for tax year 2020 for joint filers), (iii) under current law, the determination of an individual's tax liability on the long-term capital gains is based on the top long-term capital gains tax rate of 20% plus the 3.8% additional net investment income tax. The Biden tax proposal is silent as to whether the additional net investment income tax will continue to apply to long-term capital gains that are taxed as ordinary income. For purposes of this illustration, we have assumed that the net investment income tax will not apply in the foregoing case.

Effect of Mr. Biden's Tax Proposal on Executive Compensation Programs

No aspect of Biden's tax proposal is directly aimed at executive compensation programs. However, amounts earned under such programs would be subject to higher tax rates under Mr. Biden's tax proposal. We have listed below several strategies companies and individual executives might consider, if these proposed tax changes are enacted into law:

- **Increase the amount of compensation deferred under nonqualified deferred compensation ('NQDC") arrangements**. The increase in the top marginal tax rate may incent executives to increase the amount of eligible compensation contributed to a NQDC plan. Such amounts would be sheltered from individual income tax but not FICA tax (i.e., Medicare and Social Security Tax). In addition to sheltering current compensation from individual income tax, a NQDC plan would also shelter the earnings on deferrals from current individual income tax. NQDC plan deferrals plus earnings would not be subject to individual income tax until paid or otherwise made available to a NQDC plan participant.
- **Design restricted stock unit/performance share unit awards to allow the award holder to defer payment of amounts earned under the award**. The proposed increase in the top marginal tax rate may incent companies to include deferral provisions in restricted stock unit ("RSU") and performance share unit ("PSU") awards. At many companies, award agreements do not include deferral provisions (although the underlying equity plan generally allows for such provisions). By changing this prevalent design to one that allows for deferred settlement, an executive would be able to shelter additional compensation from federal income tax until the sheltered amount is paid or otherwise made available to the executive. However, such deferred compensation would be subject to FICA tax when earned, rather than when settled.
- **Change mix of long-term incentive awards to increase proportion of stock option awards (or introduce stock options)**. The Biden tax proposal could give a boost to stock options and stock appreciation rights ("SARs"). A typical stock option/SAR award has a ten-year term during which time it may be exercised, in full or in part, to the extent vested. Unlike any other equity award, this gives the award holder flexibility to determine the timing of taxation. Until exercised, any in-the-money value of a vested option/SAR is not subject to federal individual income tax or FICA tax. At time of exercise, amounts realized are then subject to these taxes.

In addition to impacting executive compensation programs, Mr. Biden's tax proposal could incent executives to sell company stock held in excess of share ownership requirements to take advantage of the current tax rate on long-term capital gains, thereby affecting the level of executive ownership of company stock at least for the short-term.

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Meridian Comment. Before the Biden tax proposal could become law, Mr. Biden would need to win the presidency and the Democrats would likely need to hold the House and gain seats in the Senate. If that is accomplished, then Mr. Biden's tax proposal would go through the normal legislative process during which it could be subject to change.

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