Potomac Perspective

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Summary

With the COVID-relief bill on the cusp of being finalized, we turn our focus to tax legislation – what it might look like and when it might pass. We discuss the Biden tax plan which is likely to be the starting point for negotiations for a tax bill and handicap the likelihood that parts of the plan will make the final cut. We also list some proposals that were not in the Biden plan and handicap the likelihood that they will be added to a tax bill. In addition, we discuss the politics of increasing taxes which differ from passing a pandemic relief bill as well as some of the strategic considerations. At this point, we think a tax bill could be enacted by late 2021, but we caution that our views are preliminary – a lot can change in the coming few months.

As Congress wraps up the latest COVID-19 relief bill, we turn our attention to what's next on Congress's agenda. In the coming few weeks, the House will vote on several bills regarding social policy that have little to no shot at passing the Senate. After that, we think that infrastructure, tax and immigration will be the main priorities for the Biden administration and Congress although the exact timing and sequencing of these items are yet to be determined. Tax and infrastructure legislation could be linked together in order for the former to help pay for the latter. At the same time, a tax hike will be toxic to Republicans which would require Democrats to go it alone and use reconciliation rules again in order to circumvent the Senate's typical 60-vote requirement. In turn, reconciliation would complicate passing an infrastructure bill as many Green New Deal items, which progressive want to include in an infrastructure bill, would not be allowed under reconciliation. These are strategic decisions which Democrats will have to make in the coming weeks.

In the meantime, we look at the Biden tax plan and try to forecast what parts of it might pass. We then explore at some relevant tax issues that were not in the Biden campaign's plan and discuss whether we think they could be added by Congress. Finally, we discuss some of the political and procedural considerations. We reiterate that the situation is fluid and elements of the plan are likely to change in the coming months.

- Biden Tax Plan
    - *Corporate taxes*
        - Raise corporate income tax rates to 28% from 21%. *Probability:* High although moderates could push for a smaller increase (perhaps 24% or 25%).
        - Impose a new 15% corporate minimum tax based on book income for companies with more than $100 million in annual income. *Probability:* Moderate. Mixing tax and accounting standards is an unusual concept which might prove too complex and controversial for some lawmakers.
        - Double the Global Intangible Low-Taxed Income (GILTI) rate from 10.5% to 21%. Probability: High.
        - Eliminate tax preferences for "fossil fuels" and "real estate". *Probability:* Moderate. The Biden plan is vague on what exactly is being targeted. Regarding real estate, we think it refers to Section 1031 like kind exchanges. Elimination has been proposed in the past, but those efforts failed.

- *Individual taxes*
    - Raise top tax rate to 39.6% from 37% for individuals making over $400,000. *Probability:* High. $400,000 threshold could be raised but probably not lowered.
    - Cap itemized deductions at 28% for incomes above about $400,000. *Probability:* Same comment regarding the threshold as for tax rates.
    - Apply payroll taxes (FICA/Social Security) on income earned above $400,000, evenly split between employers and employees. *Probability:* Low to moderate. This would create a "donut hole" in the current Social Security payroll tax -- wages between $137,700, the current wage cap, and $400,000 would not be taxed. That complexity (for employers) might turnoff lawmakers.
- *Investment and retirement*
    - Tax capital gains as ordinary income (at top rate of 39.6%) for taxpayers earning more than $1 million annually. *Probability:* High.
    - Eliminate stepped-up basis at death. Method is TBD. Possible to deem sale of assets at death or eliminate the step up but allow a carryover so capital gains only taxed when the heir sells the asset. *Probability:* Moderate. Some Democrats representing agricultural states could have a problem.
    - Increase estate tax rate to 45%. *Probability:* High
    - Lower the exemption threshold on estate taxes to $3.5 million from $11.5 million. *Probability:* Moderate. The higher exemption expires after 2025 so Democrats might opt to let the higher exemption sunset automatically.
    - Create automatic 401(k) and replace 401(k) deductions with a tax credit. *Probability:* Moderate. There is bipartisan agreement on changing retirement options.
- *Wild cards – Proposals not included in the Biden plan, but which could be added by Congress*
    - Financial transaction tax. *Probability:* Moderate. An idea that a growing number of Democrats are embracing.
    - Large bank tax. *Probability*: Low. A tax on the largest banks' liabilities failed to gain traction during the Obama administration.
    - Wealth tax. *Probability:* Low. Senator Elizabeth Warren (D-MA) is pushing, but the concept is probably unconstitutional. Also, implementation and enforcement could be complicated.
    - Market to market tax. *Probability:* Low: Senate Finance Committee Chairman Ron Wyden (D-OR) will likely push an anti-deferral tax scheme, but the complexity of the proposal could turn off some Democrats.
    - Extending the Trump tax cuts for individuals making less than $400,000. *Probability:* Moderate. The Trump tax cuts on individuals expire after 2025 and extending the cuts on people earning less than $400,000 per year could make the rest of the tax bill politically more palatable.
    - Restore full state and local tax (SALT) deduction. *Probability:* Low. Faces opposition from progressives as well as Democrats representing lower tax jurisdictions. Seen as a tax break for wealthy taxpayers.
    - Retroactivity. *Probability:* Low. Although it is possible that Congress could make any tax increases retroactive to January 1, 2021, we think that is unlikely. Retroactivity is usually controversial, and retroactively raising taxes during a pandemic would add to the controversy.

- <u>Congress's Role and Politics</u>

  Congress's role in crafting a tax bill is likely to differ from its role in the Covid-relief bill. The latter was primarily crafted by the Biden administration and was cobbled together from earlier legislation. However, there are congressional Democrats who have long waited to put their imprints on the tax code, and we doubt they will merely defer to the administration. The chairman of the tax writing committees in Congress (House Ways and Means Committee Chairman Richard Neal (D-MA) and Senate Finance Committee Chairman Wyden) probably view the upcoming tax debate and their best (and maybe only) chance at making significant changes in the tax code, so we expect they will be active rather than passive participants in the legislative process.

  The politics of a tax bill are likely to be more challenging than the politics of passing an emergency spending bill. Most lawmakers like spending money and being seen as caring and empathetic during a health crisis. However, voting for a tax bill is not as popular since it could include hard choices for key industries and political supporters back home. Centrist Democrats, who tend to represent swing districts, might have a harder time supporting parts of the tax bill. At the same time, progressives, who are frustrated that the minimum wage increase was dropped, may resist concessions to centrists whose support could be critical to the tax bill. Also, frustration among progressives could grow in the coming weeks as the House will likely pass several bills on social policy that will probably not pass the Senate. The tension between progressives and centrists could become more intense as a result. Given Democrats' razor thin majorities in both the House and Senate, any dissension could be fatal to the bill.

- <u>Timing and Process</u>

  Democratic leaders have to make strategic decisions on how to proceed. Republicans are unlikely to support a tax hike (the GOP might be fractured but opposition is still a unifying position for the party), so Democrats have to decide what the best course is for passing legislation on a party-line basis. Given the slim majorities in the House and Senate, none of the options are easy. Democrats could link an infrastructure bill and a tax bill or try and pass them separately. However, budget hawks in the party might oppose de-linking the two bills since they might want to use the tax bill to offset the spending bill. If the bills are de-linked and reconciliation rules are used to pass both of them then decisions have to be made about when to push each bill. There is some ambiguity about how often reconciliation can be used but the consensus seems to be that reconciliation can be used once in each fiscal year. The COVID bill used reconciliation for FY2021, and a tax bill and an infrastructure bill could use reconciliation for FY2022 and FY 2023. It is hypothetically possible for Congress to "reach forward" and pass a reconciliation bill for FY 2023 in late calendar year 2021 or early 2022.

  We expect that in the coming weeks (probably in April), the Democrats' strategy and timing for infrastructure and tax legislation will become clearer, but, as of now, we expect that legislative work on a tax bill will start in the spring or summer and could be debated on the House and Senate floors in the upcoming fall.

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