Post-Election Tax Policy Scenario 1: A Republican Sweep

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Two very different tax philosophies are on the ballot this election. Republicans view tax cuts as an important tool for generating economic growth, as embodied in President Donald Trump's signature law, the Tax Cuts and Jobs Act. The Democrats favor a broader economic platform, "build back better," and candidate Joe Biden's view is that a better economy is one that addresses income inequality.

In this three-part article, we discuss possible scenarios that will influence how tax policy unfolds after the votes are counted.

The first installment assumes that Republicans retain the presidency and the U.S. Senate, and flip the U.S. House of Representatives, gaining full control of both the legislative and executive branches. We discuss the issues that would be part of the GOP tax policy agenda, for example extending the tax cuts included in the TCJA currently set to expire, and other issue areas, as well as the dynamics of potential budget reconciliation legislation.

The second installment assumes Democrats sweep the House, Senate and the White House. We discuss Biden's economic and tax policy, what is likely to be on the legislative agenda to carry it out, and difficulties that may arise attempting to lower taxes in the wake of pandemic-related government spending.

The third installment looks at scenarios of divided government: (1) a continuation of the status quo or (2) the continuation of a Republican Senate and Democratic House, and the White House flipping to Democratic control. We discuss how this might impact tax aspects of COVID-19 relief legislation, domestic research and manufacturing, legislation to encourage retirement savings, U.S. participation in the international tax arena and infrastructure spending.

Doubling Down on Tax Cuts — GOP Agenda for 2021

In the event that voters give Republicans full control of government, another tax bill to extend and potentially expand the tax cuts in the 2017 TCJA will be a top legislative priority.[1] Republicans view tax cuts as an important tool for generating economic growth. A second-term Trump administration will also continue to pursue its regulatory reform agenda by further simplifying tax guidance, which Republicans also view as critical to economic expansion.

Tax Cuts 2.0 — Another Bite at the Apple

The TCJA reduced statutory tax rates and shifted the thresholds for several income tax brackets. The law doubled the standard deduction, introduced new limitations on itemized deductions, raised the alternative minimum tax threshold, doubled the estate tax exemption and significantly increased the child tax credit, among other changes. However, many of the individual provisions, and some of the business provisions, are temporary.

Since the passage of the TCJA, Trump and congressional Republicans have discussed a tax cuts 2.0 package would extend and, hopefully, make permanent various individual provisions from the 2017 bill. Another Republican tax bill would likely focus on TCJA permanence, a middle-class tax cut, and various proposals to spur investment and create jobs, including a capital gains tax rate cut.

TCJA Permanence

A second Republican tax bill would first and foremost address scheduled expirations under the TCJA. Most individual provisions expire at the end of 2025 and some business provisions expire or are automatically modified as early as 2022. It is likely that Republicans will seek permanence for most provisions enacted by the TCJA, including, but not limited to:

- Preventing further limitations on business net-interest expense;
- Avoiding a phase-down of100% bonus depreciation;
- Making the Internal Revenue Code Section 199A deduction for pass-through entities permanent;[2]
- Making alternative minimum tax relief for individuals permanent;
- Limiting rate increases for international tax provisions, including foreign-derived intangible income, global intangible low-taxed income, and base erosion and anti-abuse tax;
- Making changes to itemized deductions permanent;
- Making estate tax relief permanent; and
- Further expanding opportunity zones.

Making these provisions permanent would give investors more confidence in making a long-term commitment to economic expansion projects and risk-taking ventures that depend on tax incentives or certain treatment for an extended period to ensure profitability.

Middle-Class Tax Cuts

In February, the Trump administration announced a second round of middle-class tax cuts, promising a proposal in September. In light of the pandemic, while details remain scant, top administration officials, including National Economic Council Director Larry Kudlow, have suggested a 10% rate cut for middle-class Americans.

There are few details available on how the administration might approach a middle-class tax cut. However, one possibility is this could be achieved by consolidating the current 22% and 24% income brackets into a 15% bracket.

Another possible area for middle-class tax relief is further expansion of the child tax credit to include paid leave. One bipartisan proposal, with considerable Republican support, would modify this tax credit to allow qualifying workers to receive a $5,000 advance payment during the year following a child's birth or adoption. Qualifying individuals would repay this amount over the following decade through reductions in their child tax credit.

Families that earn too little to qualify for the full tax credit would receive a payment replacing 100% of their wages for up to 12 weeks, which they would repay through reductions in their child tax credit over 15 years.

Ultimately, this would amount to an interest-free loan, rather than a tax cut for qualifying families. The liquidity, however, would allow new parents to stay home longer with their new family members.

Capital Gains Rate Reduction

A second-term Trump administration will look at other policies that spur economic growth and investment as part of a second tax cuts package. The administration and congressional Republicans have proposed changes to the capital gains tax rate, an expansion of opportunity zone benefits, a made-in-America credit designed to create domestic jobs, and an expansion of the research and development credit.

Changes to the capital gains tax structure remain a top priority for congressional Republicans and the White House. The administration has proposed reducing the top capital gains tax rate from 20% to 15%, though it is unclear if this is inclusive of the 3.8% net investment income tax.

Since individuals who earn less than $441,450 are currently subject to a 15% long-term capital gains rate, the lower rate would apply to individuals over this income threshold. While further middle-class rate cuts are not targeted to benefit individuals in the two highest rate brackets — 35% and 37% — a capital gains rate cut is designed to benefit these individuals.

The administration has also supported indexing capital gains to inflation to encourage savings and investment. Proponents of indexing argue that a large part of capital gain is really from inflation. As a result, gains appear artificially higher and much gain caused simply by inflation is subject to tax.

To address this issue, Republicans have proposed indexing the purchase price — i.e., tax basis — of an asset for inflation, reducing the amount of gain subject to tax when the asset is eventually sold. Indexing capital gains to inflation will benefit all taxpayers, regardless of income, with the exception of those in the 0% rate bracket — individuals earning less than $40,000.

After the passage of the TCJA in 2017, the White House and congressional Republicans faced criticism for passing a bill that allowed tax cuts for individuals and families to lapse, but made the reductions for corporations permanent. This time, Republicans have focused largely on permanent extensions of the individual provisions in the TCJA.

In light of the pandemic and resulting economic downturn, the rate cut would put more money in the hands of middle-income taxpayers, giving the economy a short-term boost. In a Republican-controlled government, a potential rate reduction might be part of a package to rebuild the economy and mitigate the effects of the pandemic.

While the proposed further rate reductions focus on the middle class, higher-income individuals would also benefit from the Trump tax agenda. The reduction in the capital gains tax rate and indexing capital gains to inflation would benefit many high-income individuals.

Although rate cuts are a central tenet of Republican tax ideology, many conservatives are concerned with the mounting federal debt. TCJA permanence for individual provisions will cost upward of $600 billion, without factoring in the cost of further rate reductions. Assuming a consolidation of the 22% and 24% tax brackets, the new 15% rate would add between $0.8 trillion and $1.3 trillion to the federal debt over the next 10 years, according to an estimate by the Penn Wharton Budget Model.

Other Proposals to Spur Investment

The president has proposed an expansion of opportunity zones — a program created under the TCJA to spur investment in economically distressed areas by providing favorable capital gains tax rates for investors. It is unclear how Republicans might expand the program, but options include increasing the number of qualified census tracts, offering additional incentives for investors to work with nonprofits and expanding the program to small businesses, regardless of whether they are located in a qualifying census tract.

More recently, the president has also suggested a further corporate-rate reduction to 15%, though congressional Republicans have not embraced this proposal.

Earlier this year, the president also proposed a "made in America" program to further spur domestic investments. Proposals include: (1) 100% expensing for certain industries, e.g., pharmaceuticals and robotics, that bring manufacturing jobs back to the U.S.; (2) a tax credit for companies that bring home jobs from China specifically; and (3) a tax cut for companies that retain U.S. jobs — specifically, halving the corporate tax rate to 10.5% for firms that relocate operations to the U.S.

The president's made-in-America agenda is in part a reaction to a trade war with China, as well as the impact of the pandemic, which highlighted the downside of U.S. reliance on foreign supply chains for personal protective equipment. There are few details available on the made-in-America plan, making it difficult to gauge the potential effect.

Generally, Trump's plan is to offer incentives to companies that relocate operations to the U.S. and create American jobs, with special incentives for companies that relocate from China to the U.S. However, Trump's disincentives for offshoring seem to be largely focused on imposing tariffs on companies that relocate or expand operations outside the U.S. It is unclear whether this will be sufficient to incentivize American and foreign businesses to shift operations to the U.S.

Additionally, while rate cuts and tax credits further a pro-growth agenda, Trump's tariffs seem to have the opposite effect. According to a September study by the Tax Foundation, it is estimated that tariffs imposed so far by the Trump administration will reduce long-run gross domestic product by 0.23% and employment by 179,800 full-time equivalent jobs.

In addition to the Trump administration's proposals to spur investment, House Republicans have introduced various proposals to spur domestic investment and innovation. Proposals include continuing to allow the expensing of research and development costs in the year incurred, instead of amortizing over a five-year period beginning in 2022, doubling the research and development tax credit, and special tax treatment to help offset startup costs that businesses incur.

According to a recent report, the U.S. lags behind comparable countries in the level of tax support it provides to promote research and development. Increasing the research and development credit would be part of an effort to help spur innovation and competitiveness.

Payroll Tax Cuts

A second-term Trump administration would also likely address the August pandemic-response executive orders, which gave employers the option of postponing collection of the 6.2% Social Security payroll tax on workers earning less than $104,000 annually, or $4,000 per biweekly pay period.

While most employers have opted out of the program, the federal government has made it mandatory for federal workers. The president continues to push Congress to turn the tax deferral into a tax cut, rather than require double withholding in early 2021, which workers might perceive as a tax increase since take-home pay will go down.

Rep. Kevin Brady, R-Texas, ranking member of the House Ways and Means Committee, has already released a proposal that would create a payroll tax holiday from Sept. 1 through Dec. 31. Despite a lack of popularity among Senate Republicans, this would likely be viewed as part of a middle-class tax cuts package to avoid the appearance of a tax increase.

Regulatory Reform

The Trump administration has made a concerted effort to reduce regulatory burdens. In 2018, the U.S. Department of the Treasury and the U.S. Office of Management and Budget released a memorandum of agreement creating a new framework for the review of tax regulations. The OMB stated publicly that its review would measure the impact of the regulations on economic growth. To that end, regulatory guidance under the Trump administration favors statutory interpretation that facilitates and prioritizes growth.

For example, the regulations implementing the opportunity zone provisions established safe harbors, extended deadlines and permitted a variety of investments to qualify. The regulations were drafted to include flexibilities for investors that would increase business activity and economic investment in qualified opportunity zones. The desire to ease regulatory burdens would continue during Trump's second term.

Another Reconciliation Bill?

If Republicans sweep, their first actions on tax will likely be through a COVID-19 stimulus package that includes credits to incentivize worker retention, such as the employee-retention tax credit and an expansion of the work-opportunity tax credit, and credits to help businesses offset increased operational costs on cleaning and PPE.

Republicans may also attempt to extend certain TCJA business provisions that phase out as early as 2022 in an effort to spur growth. They may also push a middle-class rate reduction and capital gains rate cuts as part of a package to stimulate the economy.

Barring the unlikely event that Republicans secure 60 seats in the Senate, they will either need to negotiate a bipartisan bill with Democrats or once again use the budget reconciliation process to enact their tax agenda. Given how polarizing tax policy has become in recent years, it is unlikely that Republicans would be able to garner sufficient Democratic support to pass a tax bill through regular order.

Budget reconciliation only requires a majority of the senators to vote yes — which is good — but tax provisions passed in this manner typically sunset in 10 years, so true permanence for the individual provisions would still elude Republicans.

A reconciliation tax bill will come later in 2021. The TCJA was the GOP's signature legislative achievement and they will be eager to solidify this legacy by further extending its provisions. The bigger question is how and whether Republicans will pay for further extensions and expansions of the law.

Some in the party will push for reductions in federal spending to offset the cost, though this might be unpalatable to moderates in the party. Historically, it has been difficult to reduce government spending. Republicans have typically argued that there is no need to pay for extensions of existing law. Thus, it seems likely that the TCJA provisions would be extended without offsets to cover the cost.

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[1] Tax Cuts and Jobs Act, P.L. 115-97.

[2] Internal Revenue Code Section 199A.