TCM INSIGHTS

WHAT THE ELECTION OUTCOME MEANS FOR TAXES

Election Day is 11 weeks away. With the polls suggesting a close presidential race, and about one-third of the Senate and the entire House of Representatives on the ballot, the potential for a political shake-up is at the forefront of investors' minds. Since the two presidential candidates have such stark differences in policy perspectives, particularly regarding taxes, this election is significant. Several potential outcomes are explored below:

Scenario one: Biden wins, but the GOP keeps the Senate

In this case very little change is expected. A GOP Senate majority would simply not pass any legislation which would lead to a hike in taxes. If anything, the one change that the GOP might let through is the rollback / enlargement of the SALT (state and local taxes) deduction.

Scenario two: Biden wins and the Democrats also take the Senate

In this scenario Democrats could use the special budget process on Capitol Hill to raise taxes permanently with a simple majority, similar to what President Clinton did in 1993. There are five major Biden tax proposals:

1. Rolling back the top income tax rate on regular income to 39.6% (from 37%).
    - If Democrats win the Senate, a Biden Administration is likely to be successful at raising the top personal and corporate tax rate. There is no doubt that a hike to 39.6% would hinder economic growth, but the impact would likely be small. After all, that was the rate under Clinton and Obama's second term, and there was no recession in either period.
2. Rolling back the corporate tax rate to 28% (from 21%).
    - It's clear that a corporate tax rate at 21% is preferable. However, the corporate tax rate hovered around 35% from the early 1990s through 2017 and hadn't been as low as 21% since the 1930s, so a hike to 28% is still lower than where the rate has been historically.
    - Biden is also looking to implement a minimum profits tax of 15% on larger companies' GAAP earnings, but experts believe that any savvy accountant would be able to structure corporate profits to skirt this minimum tax.
3. Ending the step-up basis at death.
    - Eliminating the step-up basis at death would be an administrative nightmare for some heirs who inherit assets with no records of when the assets were originally bought or at what price. A more likely outcome, the Senate would reduce the exemption amounts for estate taxes.

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4. Treating long-term capital gains and qualified dividends as regular income for anyone earning over $1m.
    - For dividends, this would unravel roughly twenty years of tax policy progress in reducing the double-taxation on dividends, because monies are taxed when a company earns profits and then again at the personal level. On long-term capital gains, the tax rate hasn't been as high as 39.6% since the early years of the Carter Administration. As interest rates are so low, investors have been forced into stocks for growth and income (dividends). Raising the rate on long-term capital gains would be a major disincentive for investors, with lawmakers hesitant to add a further burden on investors, especially as the economy is still in the process of healing.
5. Applying Social Security payroll taxes on incomes over $400,000.
    - This is the most aggressive of the proposals. At present, that tax is 6.2% on workers and 6.2% on employers. Imposing an extra 12.4% tax on incomes over $400,000 would be a large disincentive for high-income workers. However, it's unlikely the Biden Administration would be able to impose this extra layer of payroll tax. The special budget rules in the US Senate do not apply to any aspect of Social Security- not benefits and not taxes. Changing any aspect of Social Security requires going through "regular order" in the Senate, which means the proposal could be filibustered until it gets 60 Senators willing to support it – a scenario which would seem highly unlikely.

So, undoubtedly, taxes under a Biden Administration and a Democratic Senate would move higher. And, to some degree, investors have already been expecting higher taxes down the road as the government needs to pay for all the COVID-related stimulus. However, given the fragile economic environment, analysts do not expect the Senate or Congress will have the political will to raise taxes so high and so fast that they risk sparking another recession.

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