Post-Election Tax Policy Scenario 2: A Democratic 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.

Build Back Better — the Democratic Tax and Economic Agenda

While tax cuts are at the core of Republican ideology, Democrats favor a different approach. If Biden wins the election, he will take office just three years after Trump's signature law, the TCJA, took effect.[1] Though Biden's tax plan preserves some of the overall structure of the TCJA, his proposals would dial back benefits of the tax law for corporations and wealthy individuals, using the savings to pay for programs benefiting domestic job creators and working Americans.

This is representative of Democrats' broader "build back better" economic platform and Biden's view that a better economy is one that shares prosperity by addressing income inequality.

A Robin Hood Tax Plan

Biden captured his tax policy in a simple proposition: "stop rewarding wealth and start rewarding work a little bit."

On the individual side, a Biden, if elected, would raise rates on high-income earners by restoring the top rate to 39.6% from 37%, capping the value of itemized deductions at 28%, and restoring the Pease limitation on itemized deductions for those with taxable income above $400,000.

Biden would also tax long-term capital gains and qualified dividends at ordinary income rates on income above $1 million, and eliminate the step-up in basis for capital gains. He would also phase out the Internal Revenue Code Section 199A qualified business income 20% tax deduction, enacted by the TCJA for individuals earning over $400,000.[2]

Despite the Section 199A deduction being preserved for the vast majority of small businesses, its elimination will face significant opposition, even among Democrats. Small businesses are the holy grail of American politics, and few lawmakers will be willing to pass a measure that is perceived to hurt small businesses, especially in light of the economic downturn. Moreover, determining how to phase out the Section 199A deduction will further complicate an already complex statute.

Viewed together, based on currently released proposals, Biden would largely preserve the TCJA's individual tax benefits and rate cuts for those with incomes less than $400,000. The top 1% would largely bear the highest tax burden under the Biden plan — with the top 1% of households seeing their after-tax income decline by about 16%, according to the Tax Policy Center.

Despite several tax increases on high-income individuals, Biden does not embrace the progressive platform of hefty wealth taxes for millionaires and billionaires. His platform also does not include rhetoric on eliminating billionaires as a class.

If elected, Biden will face pressure from the left flank of the party to enact punitive taxes on wealthy individuals to raise revenue for various spending proposals. Biden and other moderate Democrats will continue to resist this push — for Biden, tax increases on high-income earners are not a war on wealth, but rather a way to help working-class Americans. Ultimately, it is likely that moderates in the Senate will prevail and the type of wealth taxes championed by progressives will not pass.

To that end, Biden would use revenue generated from individual tax increases to pay for enhancements to existing tax credits and to create new incentives that benefit middle-income Americans. Biden's tax benefits for families fall into three categories: (1) assistance for caregivers; (2) housing assistance; and (3) retirement benefits.

For caregivers, Biden's plan includes enhancing the child tax credit, from $2,000 for children under 17 to $3,600 for children under 6 and $3,000 for all other children under 17; creating a $5,000 credit for informal caregivers; and changing the child and dependent care tax credit from $3,000 to $8,000 for one child, and from $6,000 to $16,000 for two or more, as well as imposing a phase-out threshold at $125,000, completely eliminating the credit for incomes above $400,000.

This is a departure from other Democratic proposals that, similar to current law, do not impose income limitations on the child and dependent care tax credit. Biden's proposal marks a major shift in tax philosophy — previously, the benefits of this tax credit went to families across the income spectrum. A household of four with two children and $1 million in income could still receive a $1,200 credit. As a result, the current credit value remains low, barely making a dent in the true cost of child and dependent care expenses.

The cost of child care alone is about $15,000 annually. The Biden proposal would significantly increase the value of the credit, allowing families with under $125,000 in income to benefit from a $4,000 to $8,000 credit, based on the number of children and dependents in the household. However, by capping the income threshold at $400,000, the Biden proposal would concentrate federal dollars on those who have the most need for the credit.

At a time when families are struggling to afford the cost of care, this proposal could make a significant difference, especially for working mothers. The pandemic has resulted in a significant decline in maternal labor-force participation and this policy could help offset the price of care, making it more cost-effective for women to return to work.

Businesses will be secondary beneficiaries of this credit. According to one national study by ReadyNation, a lack of affordable child care results in nearly $57 billion in lost wages, productivity and revenue. With so many parents juggling home and work amid the pandemic, businesses have recognized that a strong child care sector is key to long-term economic recovery and success.

For homebuyers, Biden has proposed a first-time homebuyer credit that would be refundable and advanceable up to $15,000, and a renters' credit, the housing choice voucher, to reduce rent and utilities to 30% of income, freeing up income to be used for other necessities. The Housing Choice Voucher Program is the crux of a broader housing plan — includes fair housing rules, zoning reform, construction subsidies, modifications to the low-income housing tax credit, and addressing homelessness.

The credit is championed by many Democrats who have long believed that federal housing expenditures skew too heavily toward homeownership for households with incomes of $100,000 or more. The credit also has secondary benefits that are a priority for Democrats — long-term savings will result from reducing poverty and preventing negative outcomes for children who face homelessness.

To address the retirement crisis, Biden would replace the current deduction for retirement savings contributions with a 26% refundable tax credit for each dollar contributed. The Biden campaign has not specified a percentage; this is a revenue-neutral estimate by the Tax Policy Center.

To boost income for seniors, Biden also proposes an expanded earned income tax credit for those older than 65. The retirement credit is perhaps the most controversial of Biden's individual tax proposals, in part because the campaign has released few details that would allow for a meaningful analysis.

Under current law, contributions to a 401(k) are deducted from income, incentivizing savings for those who can afford the maximum contribution limit. For those in higher-rate brackets, larger 401(k) contributions also result in larger income tax savings. The Biden-Harris proposal would replace these deductions with a flat deduction available to everyone in an attempt to equalize benefits across the income spectrum.

This is bad news for those in higher-rate brackets. Of Biden's individual tax proposals, it is also likely to face the most opposition, though the devil is likely in the still-to-be-released details.

Protecting American Jobs

Changes to the TCJA and New Book-Profits Tax

On the corporate side, the Biden tax plan centers around preserving and creating American jobs. Biden proposes to roll back certain benefits enacted by the TCJA, including increasing the corporate rate from 21% to 28% and doubling the tax rate for global intangible low-tax income earned by foreign subsidiaries of U.S. firms from 10.5% to 21%. Biden would also institute a 15% minimum book-profits tax for companies with at least $100 million in book profits.

Given the differences in determining book and taxable income, a corporation may fall in and out of owing the minimum tax on a year-to-year basis. Though corporations may still take into account foreign tax credits and net operating loss carryovers, since the proposal shifts focus to book profits, certain tax-specific calculations, such as the TCJA's expensing deduction, are unlikely to be taken into account when determining minimum tax liability. In fact, the proposal provides no clarity as to how it would deal with permanent differences between book and tax income, especially where policies differ.

For corporations, the minimum book-profits tax is a double whammy — not only will corporations face a new tax, but the inability to offset liability with tax credits will also further reduce the value of some of the TCJA's corporate tax breaks. Additionally, not allowing other credits to offset tax liability will disincentivize behavior that Democrats wish to promote.

For example, sustainability and a shift to greener sources of energy is a major priority for Democrats. However, limiting the ability of energy companies and utilities to offset their minimum book-profits tax liability with various energy tax credits will undermine the goal of incentivizing a move to green energy. Query whether Democrats will cede to inevitable pressure from industry to allow additional credits to offset minimum book-profits tax liability.

In addition to the changes discussed above, it is unclear whether Biden would seek to repeal or blunt other corporate incentives enacted under the TCJA — while some provisions such as the change to the interest expense limitation from earnings before interest, taxes, depreciation and amortization to earnings before interest and taxes are unlikely to be extended, others such as the enhanced business expense deduction might be preserved.

Made-in-America Initiative

Biden also has a slew of policies designed specifically to limit companies moving operations abroad, including a 10% offshoring penalty surtax on services and sales to U.S. customers from a U.S. company's foreign subsidiary; a claw-back provision to force companies to return public investments and deny all deductions and expensing write-offs for companies that move jobs overseas, if those jobs could have been offered to Americans; and strengthening rules against corporate inversions.

While Biden has introduced several corporate tax increases, these are somewhat balanced by his made-in-America incentives to reward good corporate actors that reshore jobs to the U.S., revitalize domestic manufacturing and spur economic development. The manufacturing communities tax credit is a key part of this initiative.

The manufacturing communities tax credit would promote revitalizing, renovating or retooling existing or recently closed down facilities. The 10% credit would also be available for projects that expand U.S. facilities to grow domestic employment or for companies that increase manufacturing wages above the pre-COVID-19 baseline of $100,000. Projects receiving the credit would have to benefit local workers and communities.

The made-in-America initiative was in part spurred by fears that the nation's supply chains are too heavily reliant on foreign countries, which set back the national pandemic response. Without personal protective equipment, ventilators and other critical equipment manufacturing located domestically, the U.S. was reliant on China and other countries for supplies.

However, the manufacturing communities tax credit tax credit alone, even when paired with other tax proposals in the plan, will not be sufficient to incentivize domestic manufacturing. U.S. multinational companies continue to pay taxes on domestic sales, while their foreign competitors do not.

Increasing the corporate tax rate reduces some of the efficacy and benefit of the manufacturing communities tax credit proposal, and once again is not competitive compared to tax rates in the United Kingdom, Ireland and other countries. Additionally, these proposals unnecessarily hurt U.S.-based multinationals that create American jobs, make significant domestic investments, and reinvest in research and development, through participation in global supply chains.

Passing a Bill

The outcome of the November elections will ultimately determine whether Biden's tax policies are ever enacted. Tax policy ultimately originates in Congress, not the White House. Unless Democrats control both the House and the Senate, most of Biden's agenda will not pass.

Assuming Democrats retain control of the House and have at least 51 seats in the Senate, tax legislation will require either an elimination of the legislative filibuster or the use of budget reconciliation, though they are more likely to use the latter.

If Democrats secure a narrow majority, the four most likely vehicles for tax legislation will be:

- COVID-19 rebuilding
- Tax reconciliation
- Health care reform
- Climate change

Expect an early focus on tax to likely be through a bipartisan COVID-19 economic stimulus package, which might include business relief, such as a cleaning credit and expansions of the employee retention tax credit, and individual relief, such as expansions of various refundable tax credits and a second round of economic impact payments.

Democrats may attempt to include infrastructure investments to spur economic activity and jobs — housing proposals that were included in the original Health and Economic Recovery Omnibus Emergency Solutions, or HEROES, Act and the Democratic infrastructure proposal might be included in a stimulus package.

Democrats will try to make the case that their housing agenda, including the renters' credit, should be part of a stimulus bill to help low-income families deal with the economic fallout of the pandemic. A few tax provisions might also be included as revenue raisers, though both parties might be reluctant to raise individual taxes if the economy continues to struggle. A COVID-19 package is likely to come together during the first few months of the new administration, as early as February.

A reconciliation bill focused on tax might follow later during the year. Here, Democrats will likely include many of the tax proposals focused on caregiving, housing and retirement. It may also include some individual tax increases, depending on the state of the economy.

Individual benefits are more likely to be paid for by corporate revenue raisers. To that end, on the corporate side, it will include many of the provisions discussed above, such as rate increases and a minimum book-profits tax, as well as a repeal of certain provisions of the TCJA. This will be partially balanced by made-in-America incentives to spur domestic manufacturing and jobs, as well as green energy tax incentives.

Subsequently, Democrats will likely seek to address long-held priorities, such as health care and climate change, giving the party more chances to push through their tax agenda. If they address health care reform, a package might include the expansion of health premium tax credits, paid for by income inequality revenue raisers such as various taxes on high-income earners and excise tax increases.

Any legislation to address climate change will also include a tax title. Proposals might include clean energy tax incentives, paid for by pilot carbon taxes and tax increases on fossil fuels.

A Difficult Path

Even if Democrats win big on Election Day, passing tax legislation will be challenging — the economic devastation left by the pandemic may lessen Democrats' political appetite for tax increases, particularly on the individual side. Without significant revenue raisers, given the growing $27 trillion federal debt, it will be difficult for Biden to pass a middle-class tax relief package.

Additionally, Biden will have to unite the various factions in his party, which have grown further apart in recent years due to the large influx of more outspoken progressive members in 2018. Progressives will prioritize a social agenda, while many moderates and business-friendly Democrats will be wary of actions that stymie economic recovery and hurt American jobs.

These competing concerns will ultimately result in a less comprehensive tax agenda — there will be tax increases, but on a smaller scale than currently proposed. Similarly, while Democrats will push for social programs and tax credits to help working-class families, cost concerns will limit relief.

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as legal advice.

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

[2] Internal Revenue Code Section 199A.