“To the Victor Go the Spoils” ... Tax Reform is Now on the Way

But will it be Incremental or Sweeping?

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In the Georgia runoff election on January 5th, the Democratic Party finished what it started last November ... winning the trifecta of the White House and control of both chambers of Congress. Currently and at a minimum over the next two years (leading up to the 2022 midterms), the sweep puts the Democrats in the driver’s seat with respect to legislation in general, and tax legislation in particular. They will head up the congressional committees, and to a large degree they will control process and procedure in both chambers of Congress.

The Backstory

With respect to taxes, Democratic proposals currently under consideration include raising an additional $4 trillion of net tax revenue over 10 years, and if enacted in full, this agenda would represent the most significant tax increase in history. If they choose to flex their newly acquired political muscle, the Democrats may be able to deliver on many, if not all, of their proposals. But the question is ... will they?

Those who believe they will point to the political campaigns leading up to both the national election last November and the Georgia runoff earlier this month. During that period Democratic Party leaders repeatedly called for tax measures to roll back much of the Trump-era tax cuts, make tax rates more progressive, curtail many business entity tax incentives, and reduce “tax expenditures” in general. The more progressive wing of the Democratic Party was even more vocal in their demands for a more redistributive tax code. Fairly aggressive tax measures ultimately found their way into the Democratic platform, and even a wealth tax was given consideration.

On the other hand, significant factors weigh against the enactment of aggressive and/or far-reaching tax legislation at the present time. First and foremost is that the Democratic majorities in both chambers of Congress are extremely narrow: a mere 12 votes out of 435 total seats in the House, and a numerical tie in the Senate which would require Vice President Kamala Harris’s tie-breaking vote. Republicans are apparently united against tax increases behind Mitch McConnell, now the Senate Minority Leader, so resistance is expected to be formidable. With this as the backdrop, no outcome is assured in light of the fact that it only takes a few defectors to derail legislation.

An added impediment to significant tax increases and/or cutbacks in tax expenditures is that our economy is currently in the throes of a pandemic. From that perspective, calling on businesses and even high-earning individuals to shoulder a higher tax burden during this time of national struggle may not play well with voters in general or in certain tightly contested congressional districts with the midterms a mere two years away. However, if the nationwide vaccination program is effective, and the pandemic subsides markedly from spring into summer, we may see less resistance to tax increases overall.

Finally, and perhaps most importantly, President-elect Biden and the Democratic leadership have indicated their strong preference for a bipartisan approach to tax reform, and after this past year of rancor and division in Congress, that’s certainly welcome news. Yet the Democrats appear to be in earnest with respect to a more progressive tax structure and—if they cannot obtain it with agreement from their Republican colleagues—it’s not a stretch to believe that they will resort to stronger means.

There are several approaches that would enable the Democrats to advance legislation that the Republicans find objectionable. These would include Executive Orders, elimination of the Senate filibuster, and the budget reconciliation process to name a few. Of these, budget reconciliation appears to be the most likely choice if push comes to shove in Congress, for the reasons discussed below.

Regarding the use of Executive Orders, the tax code would largely be immune as the U.S. Constitution requires that all tax legislation originate in the House of Representatives, and the House Ways and Means Committee is where it all starts. A President can "tinker at the edges," for example, as President Trump recently did with respect to the timing of payroll tax collections, but it is unlikely he could have changed the payroll tax rate bypassing Congress.

Using parliamentary procedure to bypass the Senate filibuster (sometimes referred to as the "Nuclear Option") has also been discussed. This approach would make use of a rather arcane Senate rule whereby a particular Senator raises a "Point of Order" and requests the presiding Senate official to change or set a new precedent. This could allow tax legislation to make its way through the Senate with the support of only a simple majority, as opposed to requiring 60 votes to end debate and proceed to a vote ("cloture").

The temptation on the part of past majorities to eliminate the filibuster has been great over the 150 plus years of its existence, and in fact, it has been partially eliminated in recent years with respect to judicial appointments. So how has it survived? Well, it appears that Senators fear its elimination would come back to haunt them in the event the political winds shift ... which they invariably do. And this sentiment seems to be present on both sides of the aisle. Although this approach cannot be ruled out altogether, it represents extremely strong medicine and thus appears unlikely unless a legislative standoff were to become particularly protracted and/or heated.

In spite of the above, however, the Democrats would still have the formidable parliamentary tool of budget reconciliation at their disposal. Its primary advantage is that it bypasses the 60 votes necessary to defeat a filibuster and thus allows legislation to advance with a simple majority. And in fact, this parliamentary maneuver has been used by both Parties with increasing frequency in recent decades, enabling passage of the 1996 Welfare Reform Act, the final version of Obamacare in 2010, and most recently the 2017 Trump tax cuts.

However, the use of budget reconciliation to advance tax legislation does not come without limitations. For example, it must be officially included within the confines of an annual budget that passes through normal congressional order, effectively limiting its use to once a year. It can neither touch Social Security, nor can it increase the federal budget deficit beyond 10 years. And as one might expect, it can significantly prolong the legislative process. But in spite of these limitations, budget reconciliation has proven to be particularly effective in passing tax legislation that faces significant opposition across the aisle.

The main point to be made by all of this is that shepherding major tax bills through Congress is no easy task, regardless of the number of seats a party holds. Case in point: the last time the Democrats controlled the White House and both chambers of Congress was during the first two years of the Obama administration (2008–2010). At that time the Democrats held larger numerical majorities than now, yet they were only able to advance one major piece of legislation, that being Obamacare, which came well into the second year of that first term. In spite of the fact that many Democrats still bemoan those two years as a squandered opportunity (and claim they will not allow history to repeat itself), they may simply have no choice but to reach compromise with the Republicans in order to advance significant tax legislation.

When Can We Expect Tax Changes? And What About Retroactivity?

From the standpoint of timing, President-elect Biden has stated repeatedly that he plans to pursue a robust legislative agenda early in his administration and has gone as far as to specifically identify initiatives that he will address on "day one" (sooner), versus others within his first 100 days in office (later). Realistically, it is conceivable that day-one initiatives could make it to the President's desk by the end of the first quarter, with the 100-day initiatives sometime in the latter half of the year.

Another factor to consider would be the potential for the retroactivity of tax reform measures. As our below referenced prior article discussed in detail, although once uncommon, retroactivity of tax as well as legislation in general has become more acceptable, within the guardrails of fairness. However, it will likely be too late for Congress to apply tax legislation passed early in 2021 retroactively to the 2020 tax year, as many returns will have already been filed prior to enactment (but see the discussion below regarding potential reinstatement of the SALT deduction).

Specific Tax Reform Measures Currently under Consideration

So what can taxpayers reasonably expect to see by way of potential changes to the tax code over the near term? For some background on the many tax reform proposals that have been presented by the Democrats over the past year, our omnibus pre-election tax article *Election Year Tax Planning* provides a comprehensive discussion. That article also addressed potential tax planning responses to particular legislative tax changes.

Proposed Income Tax Reform Measures

We now turn to the most significant pieces of tax-related legislation most likely to be brought to the floor of Congress, and probable timing. And we can start with a proposal that actually may be good news for taxpayers.

Revival of the SALT Deduction

The federal deduction for state and local taxes (the SALT Deduction), which was eliminated by the 2017 Tax Cuts and Jobs Act (TCJA) early in the Trump administration, looks to have found new life. Since its demise, the Democratic leadership has made it clear that that they wanted this deduction reinstated to further support their coastal constituents. And ironically, although it was a bone of contention throughout the negotiations for both of the recent COVID stimulus packages, the Republican Treasury recently signaled that the Internal Revenue Service would acquiesce to state “work around” legislation springing up across the country. This was unexpected and, therefore, widely viewed as signaling a softening of Republican opposition. Reinstatement of SALT may very well find its way into the earliest tax bills ... and in fact the House Ways and Means Committee recently floated the idea of temporary reinstatement of the deduction in time to apply to 2020 tax filings.

Rolling Back Significant Elements of the 2017 TCJA Tax Cuts

President-elect Biden has stated that his “day-one” initiatives will include higher tax levies on all corporations, as well as on individuals with taxable incomes in excess of $400,000. These measures can be expected to be introduced into the House fairly early in 2021, perhaps even in the first quarter of the year. In fact, there is anecdotal evidence that draft tax bills have already been prepared or are well along in preparation.

Corporations

For corporations, the marquee proposal is a rise in the corporate tax rate. Currently at 21%, President-elect Biden has expressed his preference for a 28% corporate rate, erasing one half of President Trump’s 14-point tax reduction. In addition, a minimum tax levy of 15% of net book income would be imposed on certain larger corporations which would otherwise escape taxation by the application of tax incentives elsewhere in the Code. The corporate rate increase is expected to impact choice of entity determinations, especially in light of the many pass-through entities that were toggled over to corporate tax status to take advantage of the lowered rate.

Individuals

For individuals, proposed rollbacks of the TCJA income tax cuts are both numerous and significant. And since President-elect Biden has identified many of these proposals as “day-one” priorities, we can expect to see bills introduced as early as the first quarter of 2021. The headline measures, all of which would apply to taxpayers with combined income in excess of $400,000, include the following:

- **Raising the top marginal tax bracket from 37% back to 39.6%.** This would reverse President Trump’s lowering the top rate from 39.6% to 37% in his 2017 Tax Cuts and Jobs Act (TCJA), and in order to install 39.6% as the top marginal bracket, certain of the adjacent brackets may have to be adjusted. But taxpayers should take heart. As recently as the 1960s, the top marginal tax bracket was a whopping 91%!

- **Extending the 12.4% payroll tax.** This levy currently applies to incomes up to $142,800 for the 2021 tax year. If passed, this measure alone would account for almost 50% of the total $4 trillion of tax increases being considered. But as discussed earlier, the budget reconciliation process cannot touch Social Security which, in turn, is funded in large part by the payroll tax. If the measure would have to pass pursuant to normal congressional order, its prospects would dim considerably.

- **Capping the benefit of itemized deductions at 28% and further reinstating the 3% Pease limitation as income rose above $400,000.** The TCJA eliminated most itemized deductions, and these measures would cap the few that remain.

- **Elimination of Section 1031 tax-free exchanges of real estate.** Section 1031 “like kind” exchanges were available for all business and/or investment property prior to the 2017 TCJA which winnowed its applicability solely to real estate. Republican legislators were on-board with significantly narrowing the applicability of Section 1031 in 2017, and many commentators believe that it is now vulnerable to complete elimination.

- **Capping the 20% “small business deduction” on income from certain pass-through entities.** This measure would extend the cap on the Section 199A deduction to non-service related businesses. Section 199A was originally made part of the TCJA in an attempt to equalize the after-tax treatment of corporations versus pass-through entities when the corporate rate was lowered from 35% to 21%. With the corporate rate now slated to rise, the rationale for this tax break weakens.

Proposed measures affecting individuals which would not be capped at the $400,000 income threshold include the following:

- **Changing the 401(k) deduction into a credit that is subject to specified limitations.** The 401(k) framework is essentially regressive in nature since as a deduction its benefit increases as one’s tax bracket rises. This proposal attempts to “level the playing field” by transforming the benefit into a dollar-for-dollar credit that presumably would be phased-out or capped at certain income levels.

- **Elimination of the preferential rate on carried interest income.** This tax break has survived continuing congressional scrutiny for well over a decade now, and opponents were actually successful in enacting limitations to its applicability in the TCJA. With the Democratic tax agenda squarely targeting higher earners—and fund managers are certainly higher earners—this tax break would appear ripe for elimination altogether.

- **Taxing long-term capital gains and dividend income at the 39.6 % top tax bracket where income is above $1,000,000.** The capital gains rate came into being in 1922 at a 13% rate, when the top tax bracket on ordinary income was 58%. Currently at 20%, the rate has fluctuated between a high of 35% during the 1970s, to a low of 15% early in the 2000s. A rise to 39.6% would represent the highest capital gains rate in history, and in normal times such a rise would appear unlikely. However, the outsized and highly publicized appreciation being seen across almost all asset classes, from stocks to artwork and even Bitcoin, represents a pool of potential tax revenue that legislators may be unable to resist.

Proposed Estate and Gift Tax Reform Measures

Several estate and gift tax measures are also on the table. Primarily applicable to individuals, trusts, and estates. We now highlight the proposals with the most visibility:

- **Substantial reduction of the unitary estate and gift tax exemption.** Currently the individual exemption is $11.58 million ($23.16 million per couple). The Democrats seek to lower the exemption to a “more historic level,” interpreted as the early Obama administration amount of $3.5 million ($7 million per couple). This represents an almost 70% reduction, and the possibility of its enactment is prompting many of our high net-worth clients to move assets. Some commentators believe that if retroactivity were to be imposed with respect to some tax measures, this could be a candidate.

- **Elimination of the step-up in tax basis at date of death.** If enacted, this measure would indeed generate substantial additional tax revenue over the long term. However, the step-up at death dates back to 1909, and the rationale for its existence is as strong today as it was then. To subject an asset to the estate tax at fair market value at death, and then impose the income tax upon its sale by the estate or heirs, was viewed as confiscatory as the combined tax rate could conceivably exceed 75%. Consequently, we suspect this measure would encounter a fair amount of resistance.

- **Eliminate valuation discounts for asset transfers between related parties.** This change would end a common estate planning technique whereby targeted assets are first placed within a pass-through entity, followed by the transfer of the ownership interests in that entity to heirs. Transferring those intervening interests, as opposed to transferring the assets directly, can reduce the aggregate amount subject to the estate and gift tax by up to 40% in some cases. Congress has viewed this technique with a jaundiced eye for years ... and some Democratic legislators believe that the time has come for its termination.

Conclusion

While by no means having free reign, the Democrats would appear to be in a strong position to deliver on at least some of their longstanding promises regarding tax reform. Based on their proposals to date, that reform looks to take the form of a Tax Code that is more progressive overall, eliminates certain tax incentives perceived to benefit corporations and wealthy individuals, and raises a significant amount of additional revenue to be used for societal needs. But it’s too soon to tell whether the legislative process that unfolds over the next two years is characterized more by bipartisanship or bitterness. We could sure use a lot more of the former …

Contact Us

As always, for further guidance and assistance, please reach out to your PKF O’Connor Davies tax engagement team members, or to Thomas J. Riggs at triggs@pkfod.com. We are here to help you.

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