INSIGHTS

A BLUE SENATE: TAX CONSEQUENCES

With Democrats winning both Senate seats in Georgia, President Biden will have narrow majorities in both the House and Senate. These slim majorities will most likely limit the introduction of any sweeping changes, which would normally require 60 votes, but there are a few significant tax changes which could get enacted without the required 60 votes.

Congress can use special budget procedures to pass tax hikes without the 60 Senate votes required to break a filibuster. There are several examples throughout history where, via budget reconciliation, a simple majority was enough. Examples include President Clinton's tax hikes in 1993, Bush's tax cuts in 2001 and 2003, President Obama's passage of Affordable Care Act in 2010, and President Trump's tax cuts in 2017.

It is expected that Biden will raise the top tax rate back to 39.6%. Additionally, the corporate tax rate, which was recently lowered from 35% to 21% by President Trump, will be lifted to 28%. It is clear that these tax hikes in and of themselves will do nothing to boost the economy. However, given the current fiscal deficits, higher taxes may work toward paying down some government debt. If, instead of paying down the deficit, the higher taxes go toward funding infrastructure projects, there may indeed be an offsetting boost to the economy. It is also useful to remember that the US had a top personal tax rate of 39.6% and a corporate tax rate of 35% from 1993 to 2000 and 2013-2017, with no recession during any of those years.

A welcome relief for investors living in states with high state and local taxes, analysts expect the deduction cap to be raised from $10,000 to $20,000.

Some tax proposals are less clear. For example, the Biden campaign proposed eliminating the step-up basis at death for inherited assets. This would create an administrative headache for heirs of inherited assets who do not have any documentation showing their parents' or grandparents' cost basis for those assets. It is more likely that Congress will look to lower the limit on tax-free transfer to heirs. Analysts expect the estate tax exemption to fall to somewhere between $6-7 million, versus the $11.6 million level in 2020.

On the investment side, for people earning in excess of $1 million, Biden has proposed treating capital gains and dividends as regular income. Given that this proposal would raise taxes to the highest levels since the Carter Administration, it is expected that passing this legislation through Congress would be very difficult. It is more likely to see a hike from 20% to 24% as this rate, when combined with a 3.8% Medicare tax would produce a Federal tax rate close to 28%, which is where the rate

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was when President Reagan left office in 1989. Biden is seen to have a strong political incentive to keeps rates lower than where they were under prior Republican administrations.

A major component of Biden's presidential campaign was based on his promise to implement the Social Security tax to earned income over $400,000. However, 60 Senate votes are required to break a filibuster as changes to Social Security benefits or taxes cannot be made through the budget reconciliation process. As such, it is expected that this tax proposal will not pass.

Finally, investors have been concerned about the timing of these tax changes – fearing that they would be applied retroactively from January 1, 2021. However, with COVID still depressing economic activity and unemployment rates still high, analysts expect any changes to take effect at the beginning of 2022.

David Trent
Managing Principal

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