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What can the Democrats accomplish?

Top 10 factors that will shape tax policy

Democrats enter 2021 with an aggressive platform of tax policy proposals, but face a challenging environment that could limit what's actually achievable.

Although they control all three levers of government, they enjoy only razor-thin congressional majorities and must confront a health crisis and difficult economy. The ultimate shape of tax policy enacted in the coming year will depend on a variety of political, economic, and procedural factors. See below for a discussion of 10 major considerations that will determine what tax policy looks like in 2021:

1 **Congress will flex its muscle** – President Joe Biden's ambitious tax platform received most of the attention during the campaign, but Congress is a more important partner in the legislative process. The last two major tax bills, the Tax Cuts and Jobs Act (TCJA) and the Affordable Care Act (ACA), were shaped more by congressional lawmakers than the administration. What is ultimately enacted in 2021 will depend heavily on the priorities of congressional Democrats.

2 **Moderate Democrats will have power** – The 50-50 split in the Senate will require Democrats to have complete unanimity on any tax bill that doesn't get Republican support. Moderate Democrats from red and swing states, such as Sens. Joe Manchin, D-W.V., Jon Tester, D-Mont., Kyrsten Sinema, D-Ariz., and Mark Kelly, D-Ariz., will wield significant influence. The need to secure their votes could temper what is ultimately possible. Democrats could also look to pick up votes from moderate Republicans such as Susan Collins, R-Maine, Lisa Murkowski, R-Alaska, and Mitt Romney, R-Utah.

3 **Senate operational agreement will be critical** – Although Democrats nominally control the Senate with Vice President Kamala Harris as the tie-breaking vote, they must reach a power-sharing agreement to allow for regular activity under a 50-50 split. The negotiations over the committee ratios and the process for reporting bills out of committee in the event of a tie vote will be crucial, as reconciliation requires committee action.

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4 **Reconciliation has important limits** – The budget reconciliation process may be the best option for Democrats to pass major tax legislation because it avoids 60-vote filibusters and allows for simple majority votes. Major tax bills such as the 2001 and 2003 tax cuts and both the TCJA and the ACA were all enacted using reconciliation. However, the reconciliation process has restrictions that could help shape any tax bill:

- Requires a budget resolution, which can be difficult itself
- Can only be used once per budget cycle, so Democrats will have balance priorities, although they could potentially use it twice in 2021 because no budget resolution was passed last year
- Requires committee action, which will be difficult with 50-50 committee ratios
- Cannot create a revenue loss outside the 10-year budget window, though this is more of a problem for tax cuts and not necessarily tax increases
- Every provision must have a revenue impact, which affects what can be included in an overall bill

5 **Democrats are not proposing full repeal of the TCJA** – Although Democrats campaigned heavily on reversing major aspects of the TCJA, they have not called for repealing it altogether in the same way Republicans tried to repeal the ACA altogether. This means that aspects of the TCJA likely now represent permanent shifts in policy, even if they could still be reformed. The corporate rate, for instance, may rise above 21%, but is not likely to approach anything near the old 35% rate.

6 **Economic crisis could give them deficit cover** – The threat of tax increases often arises when revenue is needed for other priorities. During a crisis, however, lawmakers are usually under much less pressure to pay for spending and tax cuts that are intended to rescue the economy. This could give Democrats political cover to ignore deficits in the short-term.

7 **Shift to fairness and policy objectives possible** – With less deficit pressure, the danger of tax increases could shift toward proposals that are seen as fairness issues, or those that Democrats believe achieve beneficial policy objectives. They could, for example, pursue tax increases on high-income individuals for fairness reasons or tighten international rules to encourage domestic investment.

8 **Economy could delay tax hikes** – Many Democrats have expressed caution about raising taxes while the economy is still fragile. Democrats could wait to pursue tax increases or delay effective dates until they feel the economy is on stronger footing.

9 **Retroactive tax increases are unusual but possible** – Retroactive tax increases are rare, but not unprecedented. Of the five rate increases since 1980, only one was retroactive. Congress passed a retroactive rate increase in August of 1993 that was made effective as of Jan. 1, 1993. A tax increase retroactive to Jan. 1, 2021, cannot be ruled out.

10 **Significant guidance shifts possible** – The Biden administration intends to act aggressively with executive action. Tax regulations have often been less politicized than regulations in other areas, but a Biden Treasury could still bring a meaningful shift, especially if Biden follows former President Donald Trump and orders a review of tax regulations issued in the past year. Much of the recent TCJA guidance has been favorable and there are generous interpretations and safe harbors that could be targeted.

Democratic control marks a major shift in the outlook for tax policy, but Democrats will still face major challenges and will be focused largely on economic recovery. The outlook for tax legislation will continue to evolve as economic conditions change, leaders flesh out their agenda and moderates assert their priorities. Taxpayers should continue to evaluate their long-term and short-term business and tax planning, particularly as more information on potential effective dates is revealed.

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