How the Election Could Impact Taxes - Transcript

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Tom Mullooly: Welcome back to the podcast. This is episode number 321. 3,2,1. Go. With me today, this is Tom Mullooly. With me today is Brendan Mullooly. Good morning.

Brendan M: Beautiful day we're having.

Tom Mullooly: Yes, it is. We both looked at a very interesting piece that landed in our mailbox from Brian Wesbury.

Brendan M: Yeah, he's the chief economist for First Trust. Brian was looking at something that I think is actually worthwhile to assess from the political spectrum. A lot of people are worried about the election this fall and what will happen to the stock market and their investments as a result of that.

A lot of that tends to be emotional in my opinion, based on where the person's political views are aligned. And that's fine. It's certainly important. However, Brian's assessment I thought was more about the facts and the policy ramifications of the possibility that President Trump is not reelected and that Joe Biden enters the White House. So looking at what people are worrying about as a result of that, setting aside just feelings. So tax policy.

Tom Mullooly: I think it's important that as you listen to this podcast, you also either right before this podcast or right after this podcast, you listen to the most previous episode that we did number 320. Because we talked about the election during that podcast as well. So the two of these podcasts pair up very nicely to get a gauge on what's happening right now.

And this is a good time to be talking about it. We're in mid to late August. We are still two and a half months out. And so this is I think, an important juncture. So let's dive right into it.

Brendan M: Brian was looking at in the event Joe Biden wins the election, one of the biggest concerns out there is that would mean higher taxes. And so Brian tried to break it down by what might that actually mean. What are the most realistic points that Biden has floated so far as things that he would want to try to get done? And then how realistic is it that they would get done based on what happens with other elections that are also going to take place in November outside of the presidential one?

Tom Mullooly: So we've got the presidential election, we've got about a third of the Senate and all of the House up for reelection.

Brendan M: The very first thing that Brian brought up was just that if Biden wins, but the republicans keep the Senate, he thinks there's very little chance of any change to tax policy, just because the republicans wouldn't go along with it.

Tom Mullooly: Welcome back to gridlock.

Brendan M: Yeah. Yeah. Which may not necessarily be the worst thing for the market. I think that outcome honestly would have not a ton of impact or meaning for us. I think here in New Jersey, one thing that Brian did say in that scenario that could be a potential outcome is just the idea of rolling back the state and local income tax cap for deductions, which would be a benefit to people in the New York metro area. Because we were the ones who were hurt by that policy.

Tom Mullooly: What's interesting though, is that if they were to change or increase the deduction for state and local taxes, that's actually a tax cut.

Brendan M: Yeah.

Tom Mullooly: That's not a tax hike.

Brendan M: Yeah.

Tom Mullooly: And everybody is-

Brendan M: That's why if the GOP continues to control the Senate, they might allow that because it is actually a tax cut, despite it being a tax cut for probably not their people.

Tom Mullooly: So the shift would have to be pretty good size. And right now there's 53 republicans in the Senate, 46 or 47, but there would have to be a pretty big shift in the local elections to swing it back to a democratic Senate. That may be a big margin right there.

Brendan M: Yeah, for sure. That was the simple one because Brian thinks the outcome would be not much. So maybe we get our uncapped deductions back for state and local income taxes, which would be positive for us and our clients. So I don't really have much to say about that. But the other scenario, I guess, that people would be more concerned about is, "Okay, so what if the democrats take the Senate, Biden is elected?" A lot more possibilities there in terms of actually getting tax policy through changes.

Tom Mullooly: So they have in Washington, what they call a special budget process. And this kind of goes outside the normal rules that Congress has set up. If there's a situation where we have Biden win, democrats now control the Senate, they may be able to push things through a little easier.

Brendan M: Right. Brian focused on the big five things like five things that he thinks the Biden administration would be pushing for. Because at this point in the election cycle, both sides of the political spectrum are talking about things that will absolutely never get done. I think Brian thinks that these are things that would realistically be on the table.

So maybe to even just narrow it down the spectrum a little more, what does it mean when people say, "If Biden wins taxes will go up?" What taxes are we talking about and who are we talking about? And is it even possible that this will happen?

Tom Mullooly: Yeah. And all we're doing today is we're really just kind of thinking through what people have been exclaiming, almost like they breathe, "If Biden gets in, we're all going to pay more in taxes." Well, wait a minute. Let's just define this and see what might actually happen.

Brendan M: Yeah. And again, these are guesses, but I think these are educated guesses that are more well-thought-out than just blanketly labeling that taxes are going up. Let's try to quantify that a little bit. So that's what Wesbury did here. And I think it's worth walking through.

Tom Mullooly: So let's talk about the five topics that a Biden administration may go after.

Brendan M: Right. So the first one that was floated is raising the top income tax rate on regular income back to 39.6% up from 37, which was in the 2017 tax cuts and JOBS Act that the Trump administration put through.

Tom Mullooly: So this top tax rate had been 39.6%. Trump was able to get it down to 37. And they're talking about one of the platforms being raising that back up to 39.6.

Brendan M: Brian didn't seem too concerned about this. He said it might be a hindrance obviously for economic growth. However, 39.6% is exactly where that rate was on their President Clinton and under President Obama's second term, when the Bush tax cuts were rolled back and we did not have a recession during either of those periods of time.

Tom Mullooly: So we actually had decent growth rates during Clinton's administration. We had slow, but we had positive growth in Obama's second term.

Brendan M: Stocks were great in both of those eras.

Tom Mullooly: '13, '14, '15, '16. Yeah, they were pretty good.

Brendan M: And under Clinton.

Tom Mullooly: Under Clinton. Let's see. When he got in, I think the Dow was around 3000 and I think when he got out in 2000, the Dow hit 10,000 for the first time. So the market tripled.

Brendan M: Not bad.

Tom Mullooly: Yeah.

Brendan M: So obviously I think, especially for certain economists, the belief is obviously that the more you're taxing people, especially at the top, the worst the economy is going to do overall. But as Brian points out, the economy has done just fine under those same sets of circumstances in the past. And that wouldn't be reason enough alone to worry about large economic ramifications or an impact on stocks just from that.

Tom Mullooly: And Brendan, I think it's important to just pause for a second here and mentioned that this is the top tax rate. It's not every dollar is going to be taxed at this rate.

Brendan M: Right. And I'm not sure the exact thresholds for single filers or for married filing jointly who that would apply to, but it's not-

Tom Mullooly: It's a very small percent.

Brendan M: It's not the average American I'll tell you that.

Tom Mullooly: Right. And in fact, normally when they make these kind of deals in Washington, they may raise the rate on the top level incomes, but everyone else in the middle may wind up getting a similar sized rate, or they may even see a tax cut.

Brendan M: It depends on how they want to do-

Tom Mullooly: There's a lot of gamesmanship.

Brendan M: Right. Exactly. So we don't know necessarily that raising the top tax rate, we don't know what effects that has down the line, but we've been there before, I guess was kind of the point from Wesbury. And it's not significant enough on a standalone basis to say that's going to end the economy or the stock market or anything like that.

Tom Mullooly: Right. So the second point that Wesbury raised was the discussion about raising the corporate tax rate to 28% from where it is now at 21%.

Brendan M: Yeah. And I thought this was a very good point that I hadn't considered when thinking about that because just in a vacuum, you think rate's going up like that on corporations it can't be positive for profits, earnings, or at least there's going to be more games being played by companies and in terms of what they're doing. But 35%, a top corporate rate was in effect through the 90s all the way until 2017.

And so again, this is something that we have been through before in terms of tax rates. And we're not even talking about going all the way back to 35 at least at this point. It seems like 28. Brian said would actually be not so bad.

Tom Mullooly: That would be a win depending on how you look at it. But yeah, as Brendan said, the previous corporate tax rate used to be 35% for a very long time from 1993 through 2017, it started with the Clinton administration. And again, the economy hummed along just fine. Market did okay.

Brendan M: The economy was scorching in the 90s.

Tom Mullooly: So I think this is something that if we only go back to 28%, that might be viewed as a win.

Brendan M: Yeah. I mean, Brian floated the idea that going back to 28% kind of sets a new ceiling on it. So that potentially in the future, maybe we're talking about 21 to 28 as the range, as opposed to 35 being in play again.

Tom Mullooly: Right. The new right lane, left lane is going to be the talk between 21 and 28%, not 35%. But he also has talked about a minimum profits tax of 15% on GAP earnings. Now GAP, G-A- stands for generally accepted accounting principles.

Brendan M: This one was interesting. And I think it's a point well made about probably all tax policy ideas is that this I think is an idea because there are some companies out there who are using accounting gamesmanship to not really show the type of profits that they're actually making and-

Tom Mullooly: All legal.

Brendan M: It is of course, yeah. They're playing by the rules that have been set. And so this would be an adjustment to those rules to say, "Hey, we see what you're doing. And we would like to tax that money because we feel that it's owed to us." However, to assume that companies are just going to accept that and not continue to play the game and find ... They're going to have their teams of accountants on this the second it's passed to try to change it again.

Companies are going to use the rules that are provided by the government and they're going to exploit them to the largest extent they can because why wouldn't they? That's been going on since the dawn of time.

Tom Mullooly: Definitely the dawn of time. And definitely what I've seen in my career. In the 70s, depreciation schedules were often for planting equipment 30 years, 40 years, sometimes 50 years. Then they started bringing personal computers into the workspace and it's like, "Hey, we can't depreciate this over 10 years. This thing's obsolete in 18-24 months. So what do we do?" Part of the Tax Equity and Fiscal Responsibility Act in the 80s that the Reagan administration put out, TEFRA, changed the depreciation schedules and they really sped up how fast companies can write-off plant and equipment costs.

And so when they talk about altering or changing depreciation schedules, it's usually as a way to kickstart businesses. It's a stimulant. And sometimes when the economy slows down or goes into a recession, speeding up or giving greater access to depreciation schedules will help speed things along. Because companies like you said, can play by the rules and they can write-off things immediately.

So now we're in a situation where you can fully expense some plant and equipment items now in the first year that they're put into service. That's gigantic. I think that if they want to rip the lid off of that and start going into this, they're going to really open up a can of worms.

Brendan M: There's unintended consequences because they create a law and there's no possible way that there are known unknowns. And so they expect, so we're going to make this rule and here's the things that we expect people will probably do. But we don't for sure. Here are the holes in it that we can see. Then there are the unknown unknowns, things that they can't possibly imagine because they've never happened before. So they put a law into place and people exploit it like what's happening now.

So they try to adapt and they'll adapt again. It's like pitchers and hitters in baseball and the tactics that they use like launch angle and throwing high heat in recent years has been a combat to the launch angle and that continues to develop over time. I think to assume that companies would just say, "Oh wow, you got us. I guess we're just going to pay more tax." That's not going to happen.

Tom Mullooly: No. And that's part of the reason why in the last 15 years we've seen more international companies and 50% of the revenues from S&P 500 companies come from outside the US. We see them moving assets, moving cash overseas because there's some economic benefit for them to do that. Good discussion. Wesbury said there may be more bark than bite to a topic like a minimum profits tax.

So the next point that he talked about was ending the step-up basis at death. Do you want to just kind of talk a little bit about what the step-up basis is?

Brendan M: If you, if you have taxable assets like a brokerage account or even like your primary residence, things outside of a retirement accounts is probably one of the simpler ways to think about it. If you leave that to your heirs, they receive a step-up in basis to say if you had a brokerage account that you put a $100,000 into and now it's worth $250,000, your heirs get it as if the cost basis is $250,000. So they don't have a taxable gain to report as you would have during your lifetime. If you wanted to unwind that and use the money for something different.

Tom Mullooly: Along the same lines, if you own a home that you bought in the 1950s for $17,000 on Long Island, and now it is $950,000 current market value, all of that gain would essentially be erased with the stepped-up cost basis at death. It's stepped-up to the cost basis, the market value on the date of death. So they're talking about ending that process.

Brendan M: Yeah. So Wesbury seems to think that's unlikely unless the democrats have a pretty large margin in Congress. He doesn't think just having the Senate by a couple of seats would get that through because there are a lot of moderate democrats who are not in favor of that. I mean, that would be not great across the aisle. Lots of people benefit from the step-up in cost basis. And maybe a compromise that Wesbury floated was the idea that maybe they lower the estate tax exemption that currently exists of $11 million roughly per individual.

And again, it's great that the exemption is where it is, but if it's between the two of those things, I would rather them walk back that 11 million by a few million dollars, as opposed to say that the average person isn't going to get a step-up in basis on their parent's home or a brokerage account or something like that. I think that more regular people in America benefit from the step-up in basis, then do the estate tax exclusion being $11 million.

I don't know what the percentage is. I'm sure we've mentioned it on prior podcasts, but the percentage of American households that are actually going to end up paying some kind of a state tax to the federal government is extremely low.

Tom Mullooly: It's very small. However, if you were to inherit these assets instead and maintain the original cost basis for stock that your daddy bought in 1958, you're going to have a big tax bill when you go to unload this stuff. So it's going to be-

Brendan M: I think that would be a lot more unpopular across the political spectrum than would be the estate tax exemption tinkering with that perhaps.

Tom Mullooly: One of the other points that Wesbury made was that treating capital gains and qualified dividends as regular income for people who have an income of a million dollars or more. A million dollars isn't what it used to be. But there's still a small percentage of people who do make a million dollars or more in taxable income each year. They are now talking about instead of taxing capital gain, which would now be 20% plus the 3.6 Medicare tax on top of that.

Brendan M: Yeah. I guess for these people, because for most it's 15%.

Tom Mullooly: Right.

Brendan M: Yeah.

Tom Mullooly: So for these people, it would be 20% plus-

Brendan M: Actually zero for some people too.

Tom Mullooly: Yes, it is.

Brendan M: Not for nothing.

Tom Mullooly: Yeah, it's worth talking about. But you're talking about now qualified dividends and capital gains being taxed as ordinary income. I think that would take the air out of the excitement of having capital gains.

Brendan M: Mm-hmm. Yeah. Well, just assuming, let's think about like who that would actually apply to. So if you're making more than a million dollars a year, then you are paying the top rates, like you said. You're paying the 20%, you're getting the extra surcharge for Medicare. So you're paying something like mid 20s percent as it pertains to federal income tax.

Yeah. I mean to jump from there to the highest tax bracket, because I would assume having a million dollars of taxable income in a year puts you up at that potentially 37 or 39.6 level. Yeah, you're talking about a lot more tax on that income.

Tom Mullooly: So the other thing dividends is that when a corporation pays a dividend to their shareholders, it's taxed. It's income that the business has paid tax on.

Brendan M: Corporate taxes.

Tom Mullooly: So now they're talking about raising corporate taxes from 21 to 28%, then they're going to pass it along if you're in the million dollar plus tax bracket, now you're talking about it being taxed again at almost 40%, 39.6. It makes you wonder how useful dividend income is going to be.

Brendan M: Yeah. Again, I think that were this to be implemented, there would be a lot of gamesmanship, not only on the personal finance level, but on the corporate level too. Maybe companies would do even more stock buybacks then.

Tom Mullooly: Sure or not pay it out as much in dividends.

Brendan M: Or retain cash. I don't know. I'm not entirely sure. And if there's going to be a threshold at a million or some other number for where you don't get the capital gains rate anymore, I think there's going to be a lot of maneuvering by individuals to get their taxable income just below that level.

Tom Mullooly: Right. So Wesbury also pointed out that the capital gains rate hasn't been as high as 39.6 since the Carter administration. So we're going back to Nixon, Ford and then during the Carter administration, they actually cut the capital gains rate.

Brendan M: Again, I just wonder how much support this would actually have in the government. Because I mean, I'm thinking of individuals here in the Monmouth County area. There are certainly people who earn more than a million dollars in a calendar year. But I think when you go to Washington D.C. and look at these people who fill up Congress, I think this is them. If they voted for this to pass this, they're voting against themselves or they're raising taxes on themselves probably. Because these are the people lining their pockets and making more than a million dollars a year. We're talking about them and professional athletes and movie stars and stuff.

I don't know. I mean, do you really think they're going to do something like that? I don't think there are enough people there who are not so self-interested that they wouldn't consider for a second. I mean, that's them and all of their biggest donors they're raising taxes on. Is that something that they're going to do?

Tom Mullooly: It could be their next platform when they run for reelection. "Hey, I raised my own taxes." Instead of I raised your taxes. Wesbury also made a really good point. We don't even know if the economy is going to be back where it was next year. And so I-

Brendan M: To float ideas like this in the event that we're not would be extraordinarily unpopular. If we're still doing rounds of fiscal stimulus next year, there's absolutely no way that any of this is happening.

Tom Mullooly: It can't. Yeah. We're going to pump the system with cash and then we're also going to raise your taxes. Unheard of. Wesbury said it was the most aggressive proposal would be to impose social security tax on regular earnings above 400 grand.

Brendan M: In this scenario, there would be like a gap I suppose from what is that? 128,000 to 400. And then at 400 again, you start getting taxed or something.

Tom Mullooly: That wasn't clear. I know that right now the threshold is 137,000. Once you get over that, it's kind of like maxing on your 401k. All of a sudden that money doesn't come out of your paycheck anymore because you hit your threshold for the year.

Brendan M: Would this idea of be like instead of raising that to 200 or something, they would say, "No, we're not going to raise it to 200. We're going to leave it where it is. And then at 400, we're going to re-institute it in some capacity?"

Tom Mullooly: I don't know even how they could do that. Because I think like you said, there'll be a lot of gamesmanship in terms of let's keep income below a certain threshold.

Brendan M: They can calculate how much revenue this would produce when they run all the computations for tax. They do this every time they cut or raise taxes and they say, "Here's how much revenue this will..." It's going to be a, what is it? They say it's going to be revenue neutral or something or the idea that a tax hike is going to give the government this much more and they can use that for these different areas, but then they probably never get the actual numbers they want because of the stuff that people do as a result of the law change, because they can't anticipate that.

Tom Mullooly: The first thing that popped into my head as we're talking about this is, I guess there's going to be a lot of partnerships and subchapter S Corps that are going to be set up if something like this were to come through. Because you don't get that social security tax on an owner's distribution.

And so, "Yeah, okay, I'll take a paycheck up to the threshold, whatever you tell me." And then after that, I'm not going to be taxed at the social security rates for this. But don't forget that social security rates, it's 6.2% on your paycheck, but it's also 6.2% on the employer side as well. And so it's really a 12.4% tax. When you put both sides together. It's a lot that goes into social security.

Brendan M: It's also a program that supports ton of people in retirement.

Tom Mullooly: Yeah. And a growing-

Brendan M: This is like a 100% of a large portion of this country's retirement income unfortunately. The way that the world is. So it's not for nothing either. Yes, it's a high cost, but it's not as if people are not then benefiting on the other side of it. Folks, if they end up collecting for roughly a decade have probably already gotten back more than they ever paid into the system. You can see how much you've paid in on the social security statements. You can download online. And usually the expected benefits are a lot higher than what most people pay in. Not counting, obviously what their employers contribute but.

Tom Mullooly: So Wesbury brought up the point that the special budget rules in the Senate do not apply for social security. So it doesn't apply to changing benefits and it doesn't apply to the tax rates. And so it would have to go through what they call the regular order in the Senate, which means the proposal could be filibustered until it gets to 60 senators who are going to support it. He thinks that's a long shot.

Brendan M: Well, yeah. I mean, depending on the kind of margin may not be possible.

Tom Mullooly: So can you bottom line this for us?

Brendan M: Yeah. I think that the point was just saying to look at this in a more cold and logical way than the feelings that are associated with presidential candidates. And just to say this election is not going to cause the United States to sink or swim. We've been through a lot of these proposals before or something similar to them. And we have elections that can change the balance in Congress. Every two years we have some kind of a vote going and every four, the president changes.

And so don't get too caught up in what happens this November, because as I said before, listen to the campaign trail and all the promises that get made and 90% of them never happen. It's hot air. So I wouldn't get too hung up on what people are saying, especially as we got closer and closer. Because I think the promises only got more outlandish the closer we get to the election.

Tom Mullooly: I agree with all of that. Good topics to cover in mid to late August as we start ramping up for an exciting and always interesting presidential race. That's going to wrap up episode 321. 3,2,1. Go. Brendan, thank you very much and we will catch up with everyone on the next episode.