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Taxing Times:

Bracing for Change or More of the Same

Rockefeller Insights

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With nearly all the votes of the 2024 general election finally counted, it is now official that Republicans will have full control of Washington in 2025 and 2026. President-elect Donald Trump will serve his second term in the White House, Republicans will remain in control of the House of Representative with a slim majority[1], and Republicans will gain control the Senate with at least a two (2) seat majority[2].

While unified control of the government could have a significant impact in many areas and on many governmental policies, tax policy is expected to take center stage sooner than later. This is especially true with the impending sunset of many of the Tax Cuts and Jobs Act ("TCJA") of 2017's provisions, which are currently legislated to sunset at the end of 2025.

HOLD ON TO YOUR TAX RETURNS: POTENTIAL CHANGES AHEAD

Extension of Prior Tax Cuts

The TCJA was one of President-elect Trump's signature achievements during his first term. The TCJA was a major tax code overhaul that generally lowered individual income taxes, estate and gift taxes, and the rate at which C Corporations pay income tax. Because the TCJA was passed using the budget "reconciliation" process, which is explained in more detail later in this Insight, the majority of the TCJA's tax cuts are "temporary" provisions and are currently legislated to sunset at the end of 2025.

This means that without Congressional action prior to January 1, 2026, the provisions of the TCJA subject to the sunset will revert to prior law.

As a result of this impending deadline, it is expected that one of the first items on Congress's and President-elect Trump's agenda will be to extend and/or make permanent many of the provisions that would otherwise sunset at the end of 2025 without Congressional action in the meantime. These include, but are not limited to, keeping the current highest tax rate for individuals at 37%, instead of 39.6%, maintaining the currently doubled estate and gift tax exemptions, and retaining the 20% deduction for the qualified business income of pass-through business entities. Please see the Appendix to this Insight for a detailed list of the most notable TCJA provisions that are currently legislated to expire at the end of 2025.

1 According to the Associated Press, as of November 18, 2024, Republicans have won 218 seats and Democrats have won 212, with 5 races still to be called.
2 According to the Associated Press, as of November 18, 2024, Republicans hold 53 Senate seats and Democrats hold 47 seats. One seat in Pennsylvania, however, is subject to a mandatory recount and has not been officially determined.

HOLD ON TO YOUR TAX RETURNS: POTENTIAL CHANGES AHEAD (cont'd)

Repeal of the State and Local Tax ("SALT") Deduction Cap:

One temporary provision in the TCJA that President-elect Trump has said he would not extend is the current $10,000 cap on the SALT deduction.

The SALT deduction essentially allows taxpayers to take a federal itemized deduction related to the taxes (income, real estate taxes, personal property taxes) they pay to state and local municipalities.

Prior to the passage of the TCJA, individual taxpayers were able to take the full amount of the state and local taxes they paid as itemized deductions, not subject to a cap. The TCJA, however, imposed a $10,000 annual cap on the SALT deduction. This cap is one of the provisions currently legislated to sunset at the end of 2025.

President-elect Trump stated during his campaign that he would allow the $10,000 cap to sunset and have the unlimited SALT deduction reinstated. Many Congressional Democrats are also in favor of allowing the SALT deduction cap to sunset.

Additional Tax Cuts & Changes:

While the temporary provisions of the TCJA are certainly front of mind for President-elect Trump and many in Congress, those may only be the starting place for significant tax policy changes.

Exempting Certain Income from Taxation and Additional Individual Income Tax Proposals:

On the campaign trail, President-elect Trump also pledged to exempt certain income from taxation altogether. Specifically, he stated that tips, overtime pay, and all social security income should not be subject to taxation.

Currently, all tips and overtime pay are subject to income and payroll (Social Security and Medicare) taxes, and whether social security income is taxed depends on the amount of the recipient's other income. If these promises ever become law, the finer details, including whether tip and overtime income would be exempt from both income and payroll taxes or just income taxes, will need to be reviewed.

President-elect Trump also proposed modifying the tax laws that apply to Americans living abroad. While short on details, President-elect Trump also pledged to make the interest paid on loans used to acquire domestically produced automobiles tax deductible.

C Corporation Income Tax Rate:

Prior to the passage of the TCJA, the profits of a C Corporation were subject to a 35% income tax. The TCJA lowered the 35% rate to 21% and unlike many of the other provisions of the TCJA, this 21% rate was considered "permanent" and not subject to sunsetting at the end of 2025.

President-elect Trump has stated that he would plan to further lower the current 21% corporate rate to 15%. While not directly impacting individual taxpayers, any change to the corporate rate could have a substantial revenue impact on the federal budget. And as detailed below, the budgetary and deficit impact of proposed legislation could have a significant impact on what tax proposals are included in any final tax legislation.

HOLD ON TO YOUR TAX RETURNS: POTENTIAL CHANGES AHEAD (cont'd)

Unwinding the Inflation Reduction Act:

A signature achievement of the Biden administration was passing the Inflation Reduction Act of 2022 ("IRA"). The IRA aimed to reduce the budget deficit through tax reform, lower prescription drug prices, and invest in domestic energy production while promoting clean energy and climate change.

On the campaign trail, President-elect Trump denounced the clean energy spending tied to the IRA and promised to halt any spending related to it. As discussed in detail below, in order to accomplish everything on Republicans' wish list from a tax policy perspective, government spending may have to be cut in certain places. The IRA may be one of those areas and tax credits relating to the IRA, including the $7,500 consumer tax credit for electric-vehicle purchases, could be on the chopping block as a result.

NAVIGATING THE LEGISLATIVE PROCESS

Clearly, President-elect Trump laid out ambitious plans in the form of tax proposals while on the campaign trail. A campaign promise, however, does not guarantee passage into law and while unified control of Congress and the White House will certainly make passing tax legislation significantly easier, there is still no guarantee that all these proposals will eventually make it into law.

Standard Legislative Process:

For a federal bill to become law, including tax legislation, both chambers of Congress, the House of Representatives and the Senate, must pass the bill before it is sent to the President for signature to officially become law[3].

For a bill to pass the House of Representatives, a simple majority of Representatives (218 of 435) must vote in favor of the bill. Similarly, for a bill to pass the Senate, a simple majority of Senators (51 of 100, or 50 of 100 with the Vice President's vote as the tiebreaker) must vote in favor of the bill.

3 Congress can override a Presidential veto with a 2/3 vote in both the House of Representatives and the Senate.

NAVIGATING THE LEGISLATIVE PROCESS (cont'd)

A bill, however, generally cannot be scheduled for a vote in the Senate until a process known as "debate" has ended. This "debate" process is what permits the delay and blocking tactic known as "filibustering," as "debate" cannot be ended until 16 Senators sign a motion to that effect and the motion is approved by three-fifths (3/5) of the full Senate. That is why it is commonly believed that you need 60 votes to pass a bill in the Senate.

While Republicans will control both chambers of Congress, the margin in the Senate (53-47)[4] will not be large enough to create a supermajority (60 votes), which is necessary to avoid a filibuster. As a result, unless seven (7)[4] Democrats cross the aisle and vote with Republicans, Democrats can block tax legislation brought under the standard legislative process.

The Budget Reconciliation Process:

Notwithstanding the standard procedure described above, certain types of legislation can be advanced using a special legislative process called budget "reconciliation." Reconciliation allows for expedited consideration of certain tax, spending, and debt limit legislation.

In the Senate specifically, budget reconciliation bills generally override the "debate" and "filibuster" rules and limit debate to 20 hours no matter what, so they can be voted on and passed with a simple majority. As a result, the budget reconciliation process has been used most frequently when the same party controls the presidency, the House, and the Senate, but lacks the 60-vote super majority in the Senate needed to overcome the "debate" and "filibuster" rules.

This will be the case for Republicans in 2025, so barring any in-fighting and holdouts, Republicans should be able to advance a significant tax and spending agenda along party lines through reconciliation. With very slim margins in both chambers of Congress, the margin for error will be extremely slim, and as Democrats saw in 2021 and 2022, a holdout of only a few members of Congress can sink proposed legislation.

Deficit Impact:

Before reconciliation can be utilized, Congressional Republicans will have to agree on the maximum budget deficit increase they are willing to tolerate over the fiscal years covered by the reconciliation measure (the "budget window," which is usually limited to 10 years), as a result of the tax legislation. This is because when reconciliation legislation is initially proposed, reconciliation instructions must be prepared that include a specific dollar amount of revenue impact over the budget window[5].

The bigger that number is, the more net tax cuts Congress can pass. With a smaller number, the more any tax cuts must be dialed back or offset with spending cuts, tax increases, or potentially tariffs. For reference, the Congressional Budget Office estimates that extending all the expiring TCJA provisions will cost $4.6 trillion over a decade. Notably, this deficit impact is before factoring in any of President-elect Trump's other campaign proposals. The Committee for Responsible Federal Budget has estimated that the full agenda, including the offset from higher tariffs, could add roughly $7.5 trillion to the debt over the next decade.

This projected increase in the deficit could create substantial tension in the Republican party between deficit hawks and tax cutters who don't think revenue losses from tax cuts need to be offset, even before specific tax proposals and provisions are negotiated. Lawmakers may have to further decide whether to enact President-elect Trump's proposed tariffs in the tax bill so the revenue can be officially counted as an offset against the tax cuts. This could also be a difficult decision for Republicans, especially those who want free trade.

4 Assuming the Pennsylvania Senate race subject to the mandatory recount is officially called for Republicans.
5 For example, the reconciliation instructions for the TCJA instructed the Senate Finance Committee and the House Ways and Means Committee to increase the deficit by not more than $1.5 trillion over 10 years.

NAVIGATING THE LEGISLATIVE PROCESS (cont'd)

The Byrd Rule:

Even without any holdouts or in-fighting on the deficit impact, President-elect Trump and Congressional Republicans may still not be able to pass all the items on their tax policy wish list.

Named for the late Senator from West Virginia, Robert Byrd, the "Byrd Rule" operates to restrict certain items from being included in reconciliation legislation. Essentially, this rule allows items that are deemed not to have a direct budgetary consequence, and therefore unnecessary to achieve the budgetary goals of the adopted resolution, to be considered extraneous and removed from the legislation[6].

One specific item that the Byrd Rule addresses relates to Social Security. The Byrd Rule explicitly states that reconciliation legislation cannot make changes to Social Security. This could provide a roadblock to President-elect Trump's proposal to exempt all Social Security income from taxation.

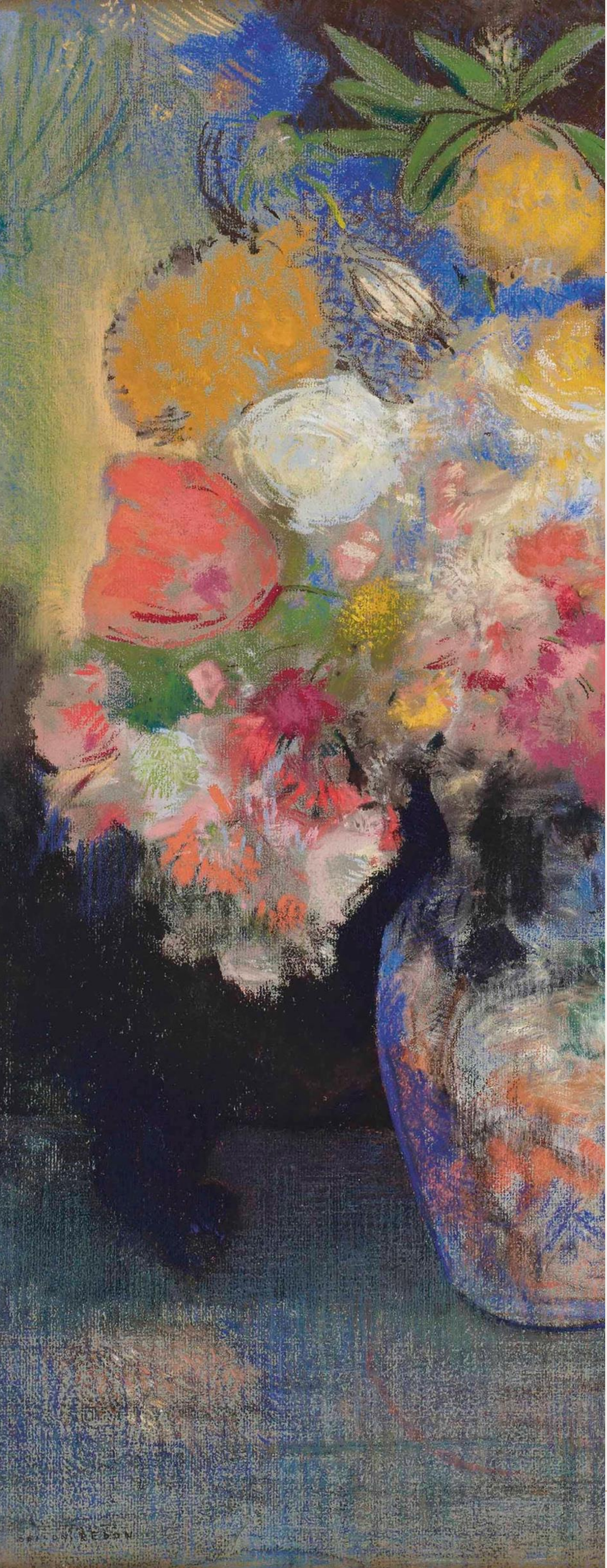
Other Byrd Rule restrictions relate to the budgetary impact of the proposed legislation, as well as the effects on the federal deficit. As mentioned above, when reconciliation legislation is initially proposed, the reconciliation instructions must include a specific amount of revenue reduction over the budget window.

One provision of the Byrd Rule could prohibit any legislation that reduces revenues (or increases outlays) if the net effect of all provisions, including any offsets, does not comply with the specific amount of revenue impact included in the reconciliation instructions. As a result, legislation that would result in revenue reduction greater than the level of reductions set in the reconciliation instructions could have to be scaled back to comply with the Byrd Rule requirements.

Additionally, the Byrd rule does not allow a reconciliation bill to increase the deficit in any year beyond the "budget window." Complying with these provisions of the Byrd Rule is why tax cuts rarely last forever and is why many of the TCJA provisions are subject to the sunset at the end of 2025.

As the estimated cost of the specific provisions in the various proposals becomes clearer, these Byrd Rule restrictions could have a major impact on if a given provision is "permanent" or "temporary" in nature, or is excluded from any final legislation altogether.

6 It is worth noting that the Byrd Rule restrictions are not automatic and require a Senator to raise a point of order that a provision violates the Byrd Rule. The Senate Parliamentarian will advise the presiding officer on whether the provision is in violation. The presiding officer typically rules on the matter in line with the parliamentarian's advice, but in either event, the full Senate can decide whether to uphold the ruling. Appealing the ruling of the presiding officer requires 60 votes to reverse the decision.



LOOKING AHEAD TO A CERTAIN, BUT UNCERTAIN FUTURE

With control of Washington unified in Republican hands, and many provisions of President-elect Trump's signature tax legislation set to sunset at the end of 2025, it is nearly certain that tax legislation is one of the first issues that Republicans will begin to tackle in January. What is less certain, however, is what exactly will be included in any proposed legislation.

A blanket extension of the expiring provisions of the TCJA may be the logical starting point and may seem nearly certain to get the proverbial "rubber stamp," but additional consideration will be necessary. Not only must President-elect Trump's campaign promises be considered, but the deficit impact, both from a Republican fiscal policy standpoint, as well as from the Byrd Rule procedural standpoint, must be navigated. Factor in slim majorities in both chambers of Congress, and the tax policy landscape in 2025 is certain to be uncertain.

Appendix

Notable Tax Cut and Jobs Act (TCJA) Provisions Set to Change at the End of 2025, Absent Legislation to the Contrary:

- The individual/trust income tax rate schedule is set to revert to the pre-TCJA brackets and rates.
  - The top individual/trust income tax rate will return to 39.6% vs. the current top rate of 37%.
- The increased gift, generation-skipping transfer and estate tax exemption amounts will sunset to the pre-TCJA amounts.
  - The inflation adjusted amount at that time will be cut in half from what is expected to be around $14,000,000 per person to $7,000,000 per person.
- The current $10,000 cap on the state and local tax deduction will expire.
  - The deduction will no longer have a cap.
- The mortgage interest deduction indebtedness limit will increase to the pre-TCJA limit.
  - Taxpayers will be able to deduct home mortgage interest on the first $1,000,000 of indebtedness vs. the current $750,000 indebtedness limit.
- Miscellaneous itemized deductions will be reinstated.
  - They are currently not deductible.
- The overall limitation on itemized deductions (“Pease Limitations”) will be reinstated.
  - The Pease Limitation is an overall limitation on itemized deductions and reduces itemized deductions by 3% of the amount by which the taxpayer’s adjusted gross income exceeds a threshold amount.
  - The total reduction is capped at 80% of total itemized deductions.
- The increased standard deduction amount will sunset and will effectively be cut in half.
- The personal exemption will be reinstated.
  - It is currently suspended.
- The current 20% Qualified Business Income (QBI) Deduction will expire and be eliminated.
- The increased Alternative Minimum Tax exemption amount and phaseout thresholds will sunset to pre-TCJA levels.
- Cash contributions to public charities will be limited to 50% of adjusted gross income.
  - Down from the current 60% adjusted gross income limit.
- The 21% corporate income tax rate will not sunset and will remain at 21%.

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