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SPOTLIGHT REPORT

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What This Year's Tax Battle Tells Us About Next Year

What's Happening: Senate GOP opposition looks poised to kill this year's bipartisan tax deal, a preview of the challenges lawmakers will face in 2025 as they try to prevent most of the 2017 Tax Cuts and Jobs Act's (TCJA) provisions from expiring in December.

Why It Matters: As with all tax fights, there is a significant delta between the two parties' approaches to the upcoming fiscal cliff. Republicans and former President Trump are seeking to make the cuts permanent and have left the door open to further lowering the corporate tax rate. Democrats and President Biden desire the opposite, hoping to raise rates on the highest earners and partially return the corporate rate to its pre-2017 level. **While neither party is interested in raising rates for middle and lower earning Americans, their different approaches to tax policy create what the Wall Street Journal estimates to be a $6 trillion cost gap between their plans.** The stark difference lends outsized importance to the November elections. In our base case scenarios for the upcoming election, we expect a victory by former President Trump to turn out enough GOP voters to maintain the House Republican majority and flip the Senate to GOP control, creating a unified Republican government. We expect a Biden victory, on the other hand, to help Democrats flip enough seats to take over the House majority, but not enough to stave off a GOP takeover of the Senate, resulting in a divided government. **While a Trump victory and unified Republican government would give the GOP wide latitude to make the 2017 cuts permanent, a Biden presidency and divided government could result in a bitter and prolonged fight over which cuts to extend.** Under divided government, the two parties will need to work together to advance a bipartisan tax package, a not so simple feat. The negotiations over any compromise legislation will run through the House Ways and Means Committee and the Senate Finance Committee. As a result, **the direction of trillions in tax policy could be heavily influenced by leadership of the two congressional chambers' tax committees: currently House Ways and Means Committee Chair Jason Smith (R-MO) and Ranking Member Richard Neal (D-MA) as well as Senate Finance Committee Chair Ron Wyden (D-OR) and Ranking Member Mike Crapo (R-ID).** Wyden and Smith are the architects of this year's struggling tax bill, which Neal begrudgingly supported, and Crapo outright opposed. Given this dynamic, **we can gain insight into how the tax writers will work together and**

what they will prioritize in the next Congress based on this year's attempt to pass the smaller, $78 billion bipartisan tax bill.

What's Next: With the Wyden-Smith tax deal unlikely to become law, we expect lawmakers to turn their attention to the expiring TCJA provisions and the larger 2025 tax fight. Biden has spelled out his plans to raise taxes on the wealthy and corporations on the campaign trail, but the specifics of how a Biden or Trump administration and their congressional counterparts will handle much of the TCJA are not yet known. As such, **it will be worth paying close attention to upcoming congressional hearings on the TCJA where we expect lawmakers will share many of their 2025 tax priorities.** House Ways and Means Committee Chair Jason Smith has already announced plans to hold a series of hearings throughout the year focused on the TCJA, and other committees such as the House Small Business Committee and the Senate Finance Committee may follow suit.

The Wyden-Smith Roadmap to TCJA Negotiations

Typically, a tax bill with broadly popular provisions – including an enhancement of the Child Tax Credit (CTC), the restoration of immediate deductions for domestic R&D expenses, expanded deductions for business interest, and immediate deductions for the cost of capital expenses, alongside other bipartisan measures – that is endorsed by the House speaker, the Senate majority leader, and the White House, should pass. But despite widespread support for the bill, Senate Finance Committee Ranking Member Mike Crapo (R-ID) stopped the Tax Relief for American Families and Workers Act in its tracks. **For tax observers, the slow death of the $78 billion tax deal in the Senate does not bode well for next year's negotiations.**

Throughout this year's tax negotiations, Crapo has been the key lawmaker to watch. **Crapo's decision to block the bill is indicative of his belief that he will become Senate Finance Committee chair in 2025, giving him greater control over the upcoming multi-trillion dollar tax negotiations.** The likelihood that Crapo holds the chairmanship next year dramatically lowers his incentive to entertain any tax legislation right now, no matter how small. Crapo's commitment to holding off on passing any tax reform until next year has withstood a robust lobbying campaign from business groups and criticism from industry and Democrats over his public opposition to only minor aspects of the $78 billion bill.

Senate Republicans appear to largely agree with Crapo's assessment. While the tax bill passed the House with overwhelming GOP support, the vast majority of Republican senators have deferred to Crapo and his opposition to the bill. Senate GOP Leader Mitch McConnell (R-KY), as well as Senators John Thune (R-SD) and John Cornyn (R-TX), both Finance Committee members and candidates to replace McConnell in GOP leadership, have stated they are following Crapo's lead. Senate Finance Committee member Thom Tillis (R-NC) told the Hill this week that he is actively trying to kill the bill, noting "I think it needs to wait and negotiate next year."

Senate Republicans' unified front against the business-friendly tax deal this year suggests tensions next year are likely to run high, and both sides may dig their heels in on their priorities. Believing they hold greater leverage in negotiations next year, Republican senators will be less likely to strike quick, bipartisan deals on the many contentious provisions of the expiring Tax Cuts and Jobs Act (TCJA). **Tillis recently indicated to Punchbowl News that Republicans could try to use Democratic priorities like the CTC or expiring Affordable Care Act expanded insurance subsidies to force Democrats' hand on a broader array of GOP priorities.**

Unsurprisingly, Senate Republicans are not alone in their belief that next year provides greater opportunity. **This year's tax fight has also shown that a subset of Democrats believe a divided government next year could give them greater leverage to negotiate a more robust CTC enhancement.** 20 House Democrats voted against the Wyden-Smith tax bill, including three members of the Ways and Means Committee. **Those Democrats, Reps. Lloyd Doggett (D-TX), Linda Sanchez (D-CA), and Gwen Moore (D-WI), believe President Biden could drive Republicans to the negotiating table on a larger CTC in a second term**. They are joined in their belief by progressive Democratic senators such as Senator Elizabeth Warren (D-MA) who criticized the $78 billion tax deal as overly business-friendly from the start.

With this in mind, it will be worth watching the positioning of Ways and Means Committee Ranking Member Richard Neal (D-MA) as the larger tax fight nears. Neal was briefed on the Wyden-Smith tax negotiations as they progressed, but was not intimately involved in the legislation's crafting. Neal also expressed reservations that the bill did not do enough for families through the CTC, but ultimately backed it, believing that something was better than nothing. **With the Wyden-Smith bill entering the rearview mirror and a shot at becoming committee chair next year, Neal may also dig in his heels over the need for a full restoration of the American Rescue Plan Act's (ARPA) CTC benefits.**

Equally important to the points of leverage unveiled by this year's negotiations is what we have learned about the relationships between the key tax writers. **Senate Finance Committee Chair Ron Wyden (D-OR) and House Ways and Means Committee Chair Jason Smith (R-MO) demonstrated their ability to work together on tax policy this year, but their decision to move forward with their $78 billion deal without sign-off from Crapo or Neal is reason for concern heading into 2025.** While Neal came around on the deal, Wyden and Smith's campaign to advance the bill in the Senate created a rift with Crapo. Both Wyden and Smith have separately suggested Crapo was closely involved in negotiations over the smaller tax bill and that changes were made to accommodate his views on the provisions he now publicly opposes. Crapo's team sharply pushed back on that narrative, leading Crapo to state, "Efforts to pressure Senate Republicans to rubber stamp the Wyden/Smith tax deal have been counterproductive…this was the risk of announcing a deal without my support and with no near-term path forward in the Senate."

Any lasting acrimony among Wyden, Smith, and Crapo from this year's negotiations

could inhibit their ability to work closely together next year, raising the odds a deal cannot be reached before the December 2025 TCJA expirations. In a statement to Punchbowl News, Wyden said, “Nobody knows what the schedule is going to be like for sure in 2025. Is it going to bleed into 2026? You certainly can’t rule that out.” Crapo similarly told the outlet Congress’ ability to complete a tax bill at all next year is a “very legitimate concern.”

One last dynamic worth considering: a handful of moderate GOP senators on the Senate Finance Committee disagree with Crapo’s opposition to the Wyden-Smith bill and want to see it passed as is. Senator Todd Young (R-IN) has consistently argued the Senate should move forward with consideration of the tax bill even if Crapo cannot secure additional modifications. Senator Steve Daines (R-MT) has similarly suggested the Senate should act this year. **If a divisive tax battle next year looks likely to drag into 2026, it will be important to watch senators such as Young and Daines to see if they lean toward compromise, or stand with Crapo and others in a push for additional wins.**

The Dividing Lines Come Into Focus

With members of both parties believing they can get a better deal in 2025, it’s worth rehashing where they stand on the major provisions. Although negotiations have not begun in full, a combination of recent Congressional hearings and the debate over the Wyden-Smith tax bill gives us insight into each parties’ top priorities for next year. One point worth noting: if Republicans gain unified control of government, one of our two base cases for election night, they will have access to budget reconciliation, a congressional process by which they can pass tax legislation with only simple majority support (50 + 1) in the Senate. In this scenario, GOP negotiators would only need to overcome internal division without regard for Democratic priorities.

R&D, Business Interest, & Bonus Depreciation

Half the cost of the Wyden-Smith tax deal is allocated to restoring a trio of tax breaks highly sought after by the business community. These include restoration of an upfront deduction for domestic research and development costs, the 100 percent bonus depreciation for capital investments, and the calculation of deductible business interest with the adjustment for amortization and depreciation. Each of these provisions was scaled back between 2021 and 2022 as part of cost savings included in the TCJA.

Republicans consider these to be some of the most important provisions to restore in 2025 tax negotiations. Rep. Ron Estes (R-KS) called the R&D deduction a “key pro growth provision that must be addressed in 2025” in a Ways and Means Committee hearing on the TCJA last week. **Moderate Democrats are more supportive of these business deductions than other corporate breaks, but Crapo and Senate Republicans’ willingness to block the Wyden-Smith bill, which included those breaks, could complicate negotiations.** Warren told Punchbowl News this week that Democrats should oppose inclusion of the business breaks altogether. **More likely, the focus on individual**

rates and the potential for a Democratic-controlled White House will force Republicans to pick and choose which business breaks they want to fight hardest for, meaning R&D, bonus depreciation, and the business interest adjustment could come at the expense of other provisions.

Pass-Through Business Income Deduction

Although the R&D, business interest, & bonus depreciation breaks were the focus of the Wyden-Smith bill, **the GOP's top business-related priority heading into the TCJA negotiations may be the 20 percent deduction for pass-through business income, otherwise known as the "199A Deduction."** The provision was the most frequently mentioned tax break by House Republican lawmakers during last week's House Ways and Means Committee hearing on the TCJA. Rep. Carol Miller (R-WV) argued the break is essential to "allowing small businesses to stay competitive [with their larger peers] and reinvest in their employees." Notably, **Rep. Lloyd Smucker (R-PA) introduced legislation last year to make the 20 percent deduction permanent, a position we expect the GOP to advocate for during next year's negotiations.**

Although Democrats are not outright opposed to the pass-through deduction, they are unlikely to support an extension in its current form. During the Ways and Means Committee hearing on the TCJA, Rep. Judy Chu (D-CA) said, "It's touted as a tremendous help to small businesses, but the opposite is true. It gives the largest tax breaks to the wealthiest individuals." **During intra-party negotiations over the Inflation Reduction Act (IRA), Democrats proposed phasing out the break for individual business owners earning over $400,000 annually and joint filers earning over $500,000, a position we would expect them to stake out again next year.**

Child Tax Credit & Earned Income Tax Credit

Democrats' top priority during TCJA extension talks will likely be the enhanced CTC, a benefit they have touted since its inclusion in the 2021 ARPA. Through ARPA, Democrats adjusted the CTC such that the top benefit reached $3,000 per child for children older than six ($3,600 for children younger than six), expanded its reach, and made it fully refundable. **As Biden laid out in his FY25 budget, we expect Democrats to make the ARPA CTC plan their starting point in negotiations over extending the tax credit.** Biden is also advocating for a permanent extension of the Earned Income Tax Credit's (EITC) enhanced benefit for childless workers.

Notably, many Republican lawmakers, including Ways and Means Committee Chair Jason Smith, support some form of an enhanced CTC. **The GOP is likely to view the CTC as one of their top bargaining chips next year – a benefit they can exchange for the pass-through business income deduction or R&D deductions.** Still, despite GOP support for an enhanced CTC, they will not agree to inclusion of the full expansion included in ARPA. **As demonstrated in the Wyden-Smith negotiations, expect members such as Crapo to push Democrats to limit the CTC's refundability and attach some form of work requirements to the measure.**

Wealth-Related Cuts

One of the most contentious issues next year will be the estate tax. **Biden and Democrats have proposed lowering the amount an individual can exempt from taxation on estate transfers and eliminating the step-up in basis adjustment** for inheritance that is greater than $5 million per individual or $10 million per married couple. **Republicans, meanwhile, are pushing for an elimination of the estate tax altogether and strongly support the step-up in basis provision.** Rep. Adrian Smith (R-NE) argued the estate tax helps "keep family businesses local and family run" during last week's Ways and Means Committee hearing on the TCJA.

Democrats also reintroduced legislation this week to tax "carried interest" as traditional income subject to the top marginal tax rate plus a 3.8 percent net investment income tax, as opposed to its current categorization under the lower capital gains tax rate. Democrats previously tried to make the adjustment as part of the IRA, but were prevented from doing so by Senator Kyrsten Sinema (I-AZ). **Trump criticized the "carried interest loophole" while in office and Republicans adjusted the duration for which assets must be held to qualify for it as part of the TCJA, but they have yet to suggest any interest in further modification during a second go around.**

Among the individual taxes over which the debate will cut across party lines, conversations around lifting the State and Local Tax (SALT) deduction cap will certainly be part of 2025 tax negotiations. Republicans instituted a $10,000 cap on the SALT deduction through 2025 to help offset the cost of the TCJA. Democrats and moderate Republicans from coastal states vehemently oppose the cap and have tried numerous times to lift it. **The majority of Republican lawmakers do not support an unlimited SALT deduction and will likely try to extend the $10,000 cap, as Bloomberg reports Trump advisors are already considering. The danger is greatest if Republicans win unified control of government, as Senate Majority Leader Chuck Schumer (D-NY) and House Minority Leader Hakeem Jeffries (D-NY) would negotiate against an extension of the cap if they hold any leverage.**

Marginal Rates

The largest portion of the expiring TCJA provisions by cost are the adjustments to the marginal income tax rates for individuals and families. TCJA lowered marginal tax rates for all taxpayers but those in the lowest income bracket and those in the 35 percent bracket and adjusted the thresholds for each bracket.

Looking ahead to next year's negotiations, the marginal rates are where the parties are closest in alignment. **Biden and Democrats hope to extend the TCJA's lowered marginal rates for all earners making less than $400,000 annually.** Under Biden's plan, only the top marginal rate would be returned to its pre-2017 level of 39.6 percent and expanded to include individual filers earning more than $400,000 annually and joint filers earning more than $450,000 annually. **Republicans will aim to make permanent all of**

the TCJA's lower marginal rates. With this in mind, **Reuters has also reported that Trump and his economic advisors are considering ways to further lower middle-class taxes. Ideas include lowering the payroll tax or further cutting rates for the middle tax brackets.**

Corporate Rate

Unlike the TCJA's individual provisions, the 2017 law's lowering of the corporate rate to 21 percent was a permanent change. As Biden spelled out in his FY25 budget, **Democrats would like to raise the corporate rate to 28 percent, a non-starter with the GOP.** While Trump and his advisors have tried to focus on his plans to lower rates for the middle class and make permanent the TCJA's individual cuts, Trump has suggested behind the scenes that he is interested in further lowering the corporate rate to 15 percent. **If Republicans win unified control of government next year, a further lowering of the corporate tax rate will be on the table.**

Revenue Raisers

The steep cost of extending the TCJA's individual cuts will likely lead members of both parties to call for offsets. **In the case of GOP unified control of government, we would expect Republicans to attempt a partial repeal of the IRA to help fund further cuts.** The IRA's clear segmentation by industry and tax credit makes it easier to repeal specific sections. **As we have written previously, we believe Republicans are most likely to repeal or at least narrow subsidies for electric vehicles, efficiency rebates, funding for the Department of Energy's Loan Program Office, the IRA methane fee, and possibly tax credits for solar investments.**

One dynamic to watch for is the difference between the House and Senate GOP's positioning on offsets. Reportedly, one of the reasons Crapo opposes this year's Wyden-Smith tax deal is because it is fully offset. **Crapo does not want to set a precedent of fully paying for tax cuts given the challenge of doing so next year.** Crapo's positioning is different from that of Smith, an architect of this year's fully paid for bill. Smith must navigate a House GOP that is more concerned with government spending and the deficit than its Senate counterparts.

Democrats, for their part, will roll out Biden's proposed suite of increased taxes on the wealthy and corporations to pay for the cuts. The overwhelming majority will be non-starters with the GOP, meaning some combination of smaller modifications to loopholes or the use of gimmicks such as early sunsets to programs, as was done with the R&D deduction under TCJA, will be required to lower the cost. Another option includes clawing back perceived overspending from previous allocations from Covid-related bills.