A Closer Look

Elections, Taxes, and Markets

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In Brief

- **The results of the upcoming presidential and congressional elections could have important implications for the financial markets and taxes.**
- **There are ways to prepare for various outcomes and take advantage of opportunities that emerge — both in investing and planning.**
- **In this *A Closer Look,* we share our thoughts on the elections, examine the candidates' tax proposals and the potential market implications, and offer planning opportunities to consider now.**

The global pandemic has hit us all, and our thoughts continue to be with those who have been impacted. All of us at Bessemer are grateful that we have been able to continue serving our clients effectively during this time. While health and safety remain our principal concern, we know there are significant financial, economic, and other challenges facing our communities.

We are also well aware of the upcoming presidential and congressional elections this November, and their results could have important implications, particularly for the markets and tax policy. In periods of uncertainty and disruption, however, we also know there are ways to prepare for various outcomes and take advantage of opportunities that emerge — both in investing and planning.

More Than Just the Election

While the media attention is starting to shift to the U.S. presidential and congressional elections on November 3, the financial markets are digesting much more than just the elections. The COVID-19 virus, and the economic shutdown and changes in consumer behavior in response to the virus, have landed us in a recession. The second-quarter GDP fell 32.9% on an annualized basis. That's not quite as bad as it sounds because the statisticians take a quarterly number (-9.5% in this case) and annualize it. Even so, the number is still bad. Earnings for the second quarter are down approximately 30%. And the unemployment rate continues to fall from its recent high, but it is still at 10.2%. The U.S. economy is in a funk, and things likely won't approach normal until we are much closer to having a vaccine.

In addition to trying to dig out of a steep recession, the U.S. is continuing to butt heads with China economically. And given that a tough stance on China seems like one of the few things that Republicans and Democrats agree on, this tension is likely to be with us after the election, regardless of who wins. There is the potential for another trade war and higher tariffs.

Election Outlook

One of the many strange but important consequences of the virus is that voters are not going to vote in the same way they have done in the past. It used to be — say, in the 1992 election — that more than 90% of people in the U.S. would vote in person on Election Day. But in 2016, only 60% of people voted in person on Election Day, and this year, it could be only a third of voters vote in person on Election Day. This different voting environment could impact turnout, delay vote counting, and increase the odds that the loser challenges the outcome.

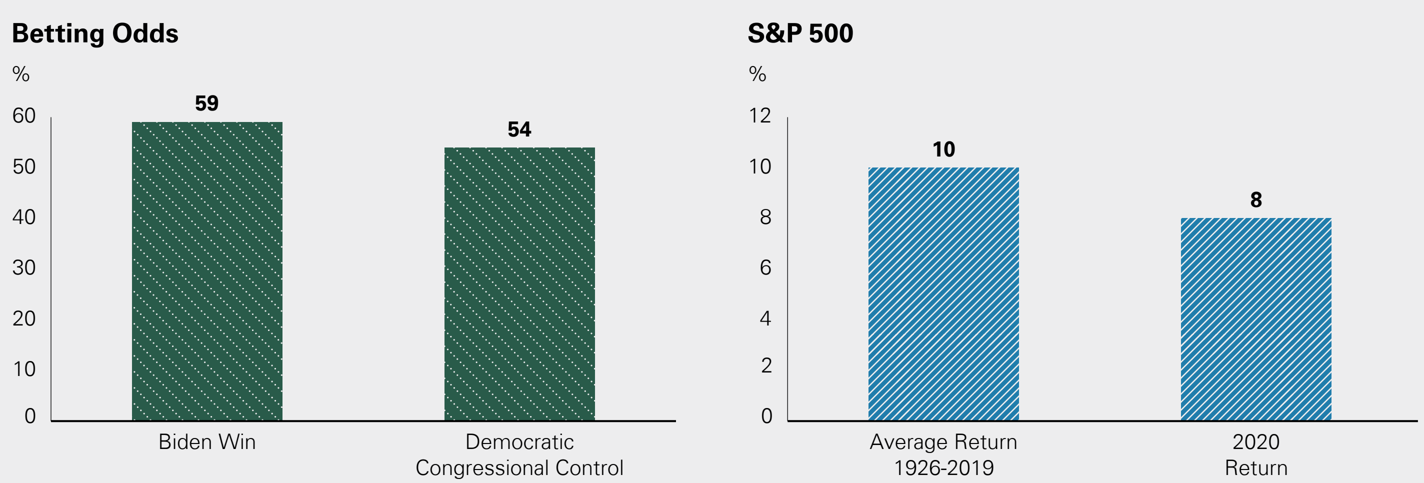
According to recent general election polling numbers, Joe Biden has a nine-point lead over President Trump. But polls didn't do so well in 2016 or in the Brexit referendum, so we look at other measures as well (Exhibit 1).

In the last month, the betting odds have moved more in favor of Joe Biden and the Democrats. Currently, according to PredictIt, Joe Biden has a 59% chance of winning the election, and the odds of Democratic congressional control are at 54%.

The economy and stock market each have some predictive value when it comes to elections. An incumbent president has a difficult time getting reelected during a recession or when the stock market is tanking. We just had a terrible GDP report for the second quarter, but the third quarter, which gets reported with an "advance" estimate on October 29, five days before Election Day (Tuesday, November 3), is expected to bounce back strongly and be up around 20%. That last-minute GDP update might have mattered more 30 years ago, but in this election, a majority of voters will have already cast their ballots by then.

The stock market has a reasonably good record of forecasting the election outcome. In general, the better the stock market is doing in an election year, particularly as the election gets closer, the more likely the incumbent gets reelected. Year to date, stocks are up 8%, staging a ferocious rally after a terrible

Exhibit 1: What Other Markets Are Saying



Betting Odds from PredictIt, 8/23/2020.

Average return for S&P 500 from 1926–2019 is compound annual return (geometric) over that period. 2020 return is year-to-date total return through 8/24/2020.

Exhibit 2: Major Tax Legislation and Congressional Control

Legislation	President		Senate	House
Deficit Reduction Act of 1993	Clinton			
Bush Tax Cuts — 2001 and 2003	Bush 43			
PPACA — Obamacare	Obama			
TCJA — Tax Cuts and Jobs Act	Trump			

Source: Bessemer Trust

start to the year. Historically, the performance of the stock market in the three months leading up to the election has tended to correlate highly with the presidential outcome; if the market is doing well, the incumbent almost always gets reelected — so stay tuned.

Tax Policy

Although, as we pointed out in our recent *A Closer Look,* "Elections and Markets Q&A," control of the White House and Congress does not have a strong correlation with stock market performance, when we look at the potential for major tax policy changes, it is quite a different story.

The Tax Reform Act of 1986 was the last time we saw bipartisan cooperation on a major tax bill. As noted in Exhibit 2, there have been four significant pieces of tax legislation since then. In each instance, one party had full control of government, and this trend is not likely to change in the near term. We would not expect to see significant tax changes enacted unless one party has a clean sweep in the upcoming election. With this in mind, a comparison of the Trump and Biden tax platforms may shed some light on potential tax changes in the event of full government control by either party.

Trump Tax Platform

President Trump has not proposed a comprehensive new tax agenda. Instead, he is looking to build on the changes enacted through the Tax Cuts and Jobs Act (TCJA) he signed into law in 2017. He would like to see the individual TCJA tax provisions made permanent. The 37% top individual rate and the 20% deduction on flow-through business income are among the changes currently slated to expire on December 31, 2025. Beyond this, Trump has signaled his desire for a capital gains tax cut and recently signed an executive order calling for the deferral of payroll tax collection (Exhibit 3).

Biden Tax Platform

Joe Biden's tax platform comprises an increased tax burden on wealthier, higher-income taxpayers along with increased corporate taxes. If enacted, it would introduce a fundamental shift in U.S. tax policy.

Estate tax/step-up in basis rules. The Biden plan would reduce the lifetime exemption amount from the current rate of $11.58 million per individual to the pre-TCJA rate of $5 million. This amount is indexed for inflation, so it would likely be closer to $5.5 million.

Exhibit 3: Tax Platforms — Trump vs. Biden

Trump — Selected Proposals	Biden — Selected Proposals
Extend the individual Tax Cuts and Jobs Act provisions set to expire at the end of 2025 • 37% top rate • 20% deduction on qualified flow-through business income	Reduced lifetime exemption amount Elimination of step-up in basis
Reduce or eliminate capital gains tax	Increased individual taxes for taxpayers with income above $400k
Payroll tax cut for employers and employees	Increased corporate taxes

Source: Bessemer Trust

A second significant change would be the elimination of step-up in basis for assets transferred at death. This would apply to all taxpayers and may disrupt many estate plans. Individuals with low-basis assets often plan to hold these assets until death, so heirs can receive a step-up in basis to fair market value. This effectively eliminates the income tax liability on the underlying asset appreciation. Under the proposed change, heirs would receive the same basis as the decedent, so they would face a significant income tax liability upon the sale of inherited, low-basis assets.

Income tax. The Biden plan would reinstate the top ordinary income tax rate of 39.6% for taxpayers earning more than $400,000, a relatively modest increase from the current TCJA level of 37%. A much more drastic rate change would apply to investment income earned by taxpayers with income over $1 million. The preferential rate on long-term capital gains and qualified dividends would be eliminated. This would effectively increase the tax rate on this income from the current level of 23.8% to 43.4% (these figures both include the 3.8% tax on net investment income).

The Biden plan would also roll back recent tax law changes for higher-income taxpayers — such as the 20% deduction for flow-through business income and the temporary rules on net operating loss income offsets and carrybacks. The plan would also seek to limit the value of itemized deductions for taxpayers with income over $400,000, and the value would be capped at 28%. As noted earlier, these taxpayers would be subject to a higher 39.6% rate, so this limitation would be a significant haircut.

Although not a stated plank on the Biden tax platform, we do believe that a Democratic clean sweep would also result in the restoration of full deductibility of state and local taxes. Senate Minority Leader Schumer from New York and other Democratic senators from high-tax states have been pushing for this for some time. Exhibit 4 provides a summary of the Biden tax proposals for individuals.

Corporate tax. There are three main corporate tax proposals in the Biden tax platform. The first is an increase in the corporate tax rate from 21% to 28%. This is halfway back to the 35% rate in effect prior to TCJA. He would also seek a new 15% minimum tax on corporate book income and an increase in the tax on profits earned by foreign subsidiaries.

Exhibit 4: Biden — Individual Tax Proposals

Proposal	Who It Would Affect
Top rate on ordinary income increase to pre-Tax Cuts and Jobs Act level of 39.6%	Would apply to taxpayers with income exceeding $400k
Qualified dividends and long-term capital gains taxed as ordinary income	Would apply to taxpayers with income over $1 million; top tax rate would increase to 43.4%
Earned income above $400k would be subject to social security tax	Creates a gap from $138k to $400k
Limit value of itemized deductions to 28%	Would apply to taxpayers with income exceeding $400k
Restrict other Tax Cuts and Jobs Act provisions and CARES Act provisions	199A deduction phased out for taxpayers with income exceeding $400k; repeal of NOL offset and carryback changes
Restore deduction for state and local taxes?	Not a specific Biden proposal, but would be pushed by Schumer and others

Taxes in the Spotlight

One of the reasons that taxes are a hot topic right now is that the U.S. has had a significant ramp-up in government spending and fiscal support in response to COVID-19. And we believe this fiscal policy support ($3 trillion and counting), coupled with monetary policy, has been helpful to the stock market and economy in preventing a worse downturn. But even before the COVID crisis, we as a country were not doing a great job balancing our spending with our revenues, or taxes.

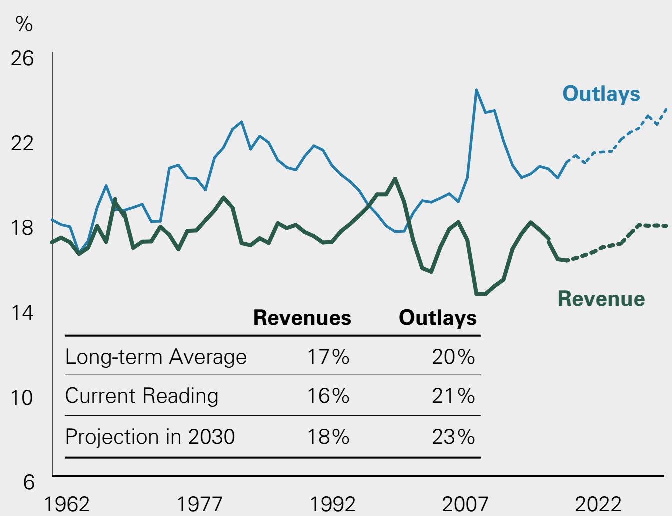
Exhibit 5 charts spending and taxes as a percentage of GDP over time, going back to the early 1960s, and also includes projections from the Congressional Budget Office (CBO) for the next 10 years. Right now, we are spending about 21% of GDP, but our tax revenue is closer to 16% of GDP, a deficit of 5% of GDP.

From the early 1960s up to now, spending has eclipsed revenue by about 3% per year on average. And looking at the projections on the right side of the chart, which are the dotted lines, this is likely to get worse, in large part based on increased healthcare and social security spending as Americans age.

Now, there is a camp of people who believe that deficits and debt do not matter. As long as you can grow faster than your cost of borrowing, you should be fine. We at Bessemer don't really see it that way — we believe debt and deficits do matter, and if the U.S. ever gets to the point where investors worry about its fiscal stability

Exhibit 5: Outlays Not in Line With Revenues

U.S. Federal Budget With Outlays and Revenue as a Percent of GDP



	Revenues	Outlays
Long-term Average	17%	20%
Current Reading	16%	21%
Projection in 2030	18%	23%

As of March 2020. Dashed line indicates CBO forecast.

Sources: Congressional Budget Office; Office of Management and Budget or its ability to pay back the money it borrows, the U.S. will no longer enjoy the same privileges in the market that it does today. Today, the U.S. is still the world's safe haven, the world's reserve currency, and the world's risk-free rate, and the U.S. gets to borrow money very cheaply (the government can borrow money for 10 years at 7/10 of 1%). But this is not a divine right. And if the U.S. lets debt and deficits get completely out of control, it will likely be in a less advantageous position in the future. The U.S. will likely need to either cut spending, raise tax revenue, or do some combination of each in the near future.

Implications of Potential Tax Changes

Some investors are worried that Democratic control would lead to higher taxes, and this fiscal contraction would sidetrack the economy and the stock market. This outcome is possible, but the Democrats are also supportive of an infrastructure package, and were this to pass, it could offset some of the fiscal tightening from higher taxes. Let's focus specifically on Joe Biden's plan to raise the corporate income tax rate from 21% to 28%. Were this to happen, one direct impact is that, with higher tax rates, the after-tax earnings of U.S. companies would go down.

Exhibit 6: Impact on Earnings From Corporate Tax Hike

Source: Strategas

In Exhibit 6, 2020 earnings for the S&P 500, on the far left, are estimated at $125. Absent the tax increase, earnings are forecast to bounce back after a difficult COVID-related 2020 and be up 30% to roughly $162. However, were the corporate tax rate to rise to 28%, this would shave approximately 10% off next year's earnings.

The tax increase would have a larger impact on U.S.-focused companies, as they would see more of their earnings subject to that higher tax rate. In general, smaller companies tend to be more U.S. focused, so on a relative basis, the tax increase could have a bigger impact here. It's also important to remember that companies are dynamic. As a result of higher taxes in the U.S., companies may make different decisions about how they invest or reinvest their money. But they also may not — if the U.S. market is viewed favorably compared to other markets, which it likely still will be, the impact may not be dramatic. Higher tax rates are definitely something to keep in mind, but they aren't the only thing. Investors, and the companies investors are investing in, have many other important variables to consider, including the cost of capital and the opportunities in the U.S. and abroad.

There are many important questions yet to be answered: Will Joe Biden win? Will the Democrats keep control of the House and take control of the Senate? If the Democrats were in control, would they raise taxes even if the economy was still in recession? Will the actual legislation match the campaign priorities?

Investment Conclusions

With so much uncertainly, we are not likely to make big shifts in asset allocation in anticipation of election outcomes that we can't predict. The polls and betting markets today give the Democrats a slight edge, but the odds aren't that much better than a coin toss. And historically, it hasn't been a winning strategy to dramatically rearrange your portfolio every four years in anticipation of or response to an election.

Our portfolio managers are contemplating the potential stock and sector impact of various election outcomes — for example, the prospects for technology, healthcare, financial, and energy companies in a Trump versus Biden presidency. We do expect the markets to stay choppy, and perhaps get even choppier, whether because of election uncertainty, COVID-19 news, or more heated trade rhetoric with China. We remain comfortable with our slightly defensive positioning, where we are generally taking a little bit less risk as compared to our benchmarks.

Planning Considerations

It is important to have a high degree of certainty when considering significant tax planning moves. For this reason, we normally suggest strategies that can be implemented in the current year, where the rules are known and generally not subject to change. Even in the event of a one-party clean sweep in November, there is no guarantee the policies they espouse now will be enacted. With this in mind, we highlight some tax planning considerations in the context of one-party control of the government in 2021:

Republican control. With a Trump win and full control of Congress, tax rates are not likely to rise next year, and the tax rate on capital gains might even decrease. In such a case, we would suggest deferring income and gains into 2021, where possible, and accelerating deductions and losses into 2020 to offset income potentially taxed at a higher rate.

For 2020 only, charitable contributions can offset up to 100% of adjusted gross income. Combining a Roth IRA conversion with a large charitable gift can offset some or all of the inherent tax cost to convert. Additional lifetime gifts should also be considered as the increased exemption amount enacted as part of TCJA is scheduled to expire at the end of 2025.

Democratic control. As noted earlier, the Biden tax platform would represent a significant change from current policy and increase the tax burden for higher-income taxpayers. A main focus area would be long-term capital gains. The tax rate on this income item would nearly double from 23.8% to 43.4% for those with incomes above $1 million. Taking gains in 2020, when we know the rate is 23.8%, would be an option to consider. Also, to the extent that low-basis positions are being held with an eye toward basis step-up at death, a Democratic sweep may remove this as a planning option. As such, diversification (for those with concentrated wealth) may be preferred to holding low-basis assets where tax rates could rise.

It may be beneficial to hold off on taking long-term capital losses in 2020 as they could be more valuable in the future if the preferential rate on long-term gains is eliminated. However, it probably would not make sense to defer deductions into 2021; a Biden proposal to cap the benefit of itemized deductions at 28% would significantly erode their value. One exception would be state and local income and property taxes. In the event of a Democratic sweep, full deductibility could be restored in 2021, so consider delaying payment until January 2021, where the deduction may no longer be capped at $10,000.

A Biden win and full Democratic control could mean a quicker return to the pre-TCJA lifetime exemption amount of $5 million per person (indexed for inflation). To the extent that one has remaining lifetime exclusion amounts available, additional gifting in 2020 should be considered.

We believe potential tax changes are important to consider, but they should not dictate a family's plan. Rather, planning should be done with a long horizon in mind based on each family's unique goals, priorities, and values. As always, Bessemer's client advisors, as well as tax, legal, and investment teams are available to help discuss how to optimize planning in the current environment.

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