Tax Policy Outlook After the Midterm Elections

What could the 2026 midterms mean for future tax policy? Bill Cass, Director of Wealth Planning at Franklin Templeton, examines potential changes and planning considerations.

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The 2026 midterm elections could have significant implications for the future direction of federal tax policy. While Democratic control of both the House and the Senate may not have come as a surprise, the sheer number of seats gained in both chambers was largely unexpected. As we head into 2027 with a divided government, the prospects for broad tax increases in the short term remain unlikely. However, these larger-than-expected majorities in both chambers may signal a shift in the legislative landscape following the next election. A return to unified Democratic control could bring renewed attention to some of the proposals that emerged during the previous administration, with potentially significant implications for higher-income households. Looking ahead to the 2028 election, Republicans will face a higher hurdle in their efforts to regain congressional majorities. The 2026 midterms may ultimately prove to be an early indicator of a more consequential shift in tax policy after 2028.

Risk of Higher Taxes for Some Households?

Regardless of the political landscape, the nation's growing budget deficits and the long-term funding challenges facing Social Security and Medicare put additional pressure on lawmakers to consider revenue-raising measures. One indication of the types of tax increases that could be considered emerged in 2021 as the House of Representatives passed the *Build Back Better Act* (H.R. 5376), a sweeping legislative package that included initiatives across a broad range of areas including childcare, education, health care, and climate-related programs. The legislation also included several tax increases targeting higher-income households. Ultimately, this legislation failed to pass the Senate. However, certain tax policy proposals included in the *Build Back Better Act*, along with other measures favored by Democratic lawmakers could foreshadow potential tax policy priorities in 2028 and beyond. Here are some tax proposals that were discussed during the Biden administration, including some that were included in the *Build Back Better* legislation.

Tax Policy Area	Potential Provisions
Individual taxpayers	• Raise the top marginal tax rate on ordinary income from 37% to 39.6% • Increase the top tax rate on long-term capital gains and qualified dividends to 25% (28.8% including the 3.8% surtax on net investment income) • Tax long-term capital gains and qualified dividends as ordinary income for households with income exceeding $1 million • New surtaxes on higher income levels (e.g., an extra 3% surtax applied on household income greater than $5 million)
Wealth transfer	• Reduce the lifetime unified gift and estate tax exclusion (some lawmakers have proposed as low as $3.5 million per person)

	• Repeal step-up in cost basis treatment of property at the death of the owner • Include assets held within irrevocable grantor trusts in the estate of the deemed owner (i.e., the grantor) • Restrict the ability to utilize valuation discounts on the transfer of closely held business ownership shares • Eliminate use of advanced wealth transfer strategies (dynasty trusts, certain grantor-retained annuity trusts for example)
Retirement accounts	• Limit aggregate balances in retirement accounts to $10 million per person • Eliminate the ability to convert after-tax retirement savings to a Roth account (i.e., the "backdoor Roth strategy") • Prohibit Roth conversions for taxpayers at higher income levels ($400,000 for individuals, $450,000 for couples has been proposed previously)
Business owners	• Increase the tax rate on C-Corporations • Apply the 3.8% net investment income surtax to "active" business income (currently only passive business income is subject to the tax) • Prohibit higher-income households from claiming the 20% deduction for qualified business income (QBI) • Limit the capital gain exclusion on Qualified Small Business Stock (QSBS) to 50% (from the current maximum exclusion of 100%)
Real estate	• Limit like-kind exchanges of real estate through Section 1031 (set maximum capital gains deferral of $500,000 or $1 million for couples)
Social Security and payroll taxes	• Increase the payroll tax (currently 6.2% for individuals) • Raise or eliminate the wage threshold for payroll taxes to apply ($192,300 for 2027) • Increase the taxation of Social Security benefits

Planning Ahead While Keeping a Close Eye on Policy Developments

While the proposals outlined above provide a glimpse of potential tax policy changes that could emerge in the years ahead, the ultimate direction of tax legislation remains uncertain. Again, major tax law changes over the next two years are unlikely, but policy direction longer-term is uncertain. Although it is important for individuals and families to understand how potential changes could affect their financial and estate plans, making significant planning decisions based on anticipated changes in tax law can produce unintended outcomes. For example, some families accelerated gifting ahead of the expiration of the *Tax Cuts and Jobs Act* (TCJA) since the lifetime exclusion for estates and gifts was scheduled to be

reduced by half. However, the *One Big Beautiful Bill Act* signed into law in 2025 actually increased the exclusion amount. As a result, some assets may have been transferred to irrevocable trusts or held in other complex arrangements that may not have been necessary.

Rather than attempting to predict future tax legislation, individuals and families can take steps today to build greater flexibility into their financial plans. One example is increasing tax diversification by holding assets across taxable, tax-deferred and tax-free accounts, providing greater flexibility to manage taxable income and distributions as tax laws and individual circumstances evolve. Similarly, working with an estate planning attorney can help individuals develop a wealth transfer plan that incorporates optionality to adapt to the prevailing tax and legal landscape. Ultimately, individuals should work with their financial, tax, and legal professionals to evaluate planning strategies in the context of their broader financial objectives, while maintaining flexibility to adapt as the legislative landscape evolves.

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