

Budget Control Act of 2011

August 1, 2011

Special Report

HIGHLIGHTS

- Tax Reform Linked To Deficit Reduction
- Fate Of Bush-Era Tax Cuts Unclear
- AMT Proposed To Be Abolished
- Corporate Tax Preferences Under Fire
- Lower Corporate Tax Rate Possible

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White House And Congressional Leaders Agree To Raise Debt Ceiling; Create Joint Committee On Deficit Reduction

With an August 2 deadline looming, President Obama and Congressional leaders have reached an eleventh hour agreement to raise the federal debt limit. The two-part debt deal includes creation of a joint select committee of Congress to determine additional deficit reduction measures before year-end.

At press time, it is unclear what changes to the Tax Code may be addressed by the joint committee. In recent months, tax proposals from both sides of the aisle raised as part of the current deficit debate have included bold, sweeping changes. Many of these changes could be part of the joint committee’s recommendations.

IMPACT. *The mere fact that sweeping tax reform is now being considered in connection with solving long-term deficit problems indicates a desire by many in Washington not just to fine tune around the edges of the tax law but to seriously consider fundamental changes. Both sides see the economy growing through a fairer tax system. Add to that catalyst the reality that the Bush-era tax cuts are scheduled to automatically sunset after December 31, 2012 if Congress takes no action and a major round of tax legislation not seen since the 1986 Tax Reform Act becomes not only possible, but also more probable.*

COMMENT. *The joint committee has a short window to complete its work. Under the terms of the debt-ceiling agree-*

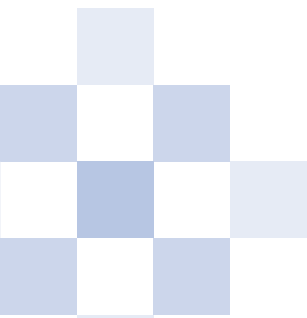
ment, the joint committee will make its recommendations in late November and Congress will vote on them under expedited procedures before the end of 2011.

Eleventh Hour Agreement

Late on July 31, President Obama announced that Democrats and the GOP had reached an agreement on a deficit reduction package that would cut spending but includes no revenue raisers at this time. The first part of the agreement is expected to cut approximately \$1 trillion in federal spending over 10 years. The second part of the agreement creates a 12-member joint committee, which is charged with the goal of reducing the federal deficit by at least \$1.5 trillion over 10 years. If the joint committee cannot agree on legislative language or Congress fails to take up the joint committee’s proposal, automatic spending cuts would apply.

COMMENT. *President Obama said “everything will be on the table,” when the joint committee begins its work.*

COMMENT. *In announcing the deficit reduction agreement, President Obama said, “we have to ask the wealthiest Americans and biggest corporations to pay their fair share by giving up tax breaks and special deductions.” Many Republicans on the other hand also see the opportunity for tax reform as consistent with their vision for an across-the-*



board reduction of tax rates as a way to grow the economy and bring in more revenues. To achieve rate reductions in a revenue neutral package of reforms, however, certain deductions, credits and other current tax benefits would need to be trimmed or eliminated.

IMPACT. *The relatively short deadline for legislation as required under the deficit deal all but guarantees that only a first step –albeit a significant one–toward sweeping reform can be taken by year-end 2011. Further, changes made under legislation required under the debt-limit agreement are expected to be tied to the sunset of the Bush-era tax cuts and, therefore, would not be effective until 2013.*

TAX PROVISIONS UNDER CONSIDERATION

In addition to spending cuts, the deficit reduction debate has generated a significant number of tax proposals. Many of these proposals would have been considered “extreme” only a few years ago but are now under serious consideration due to the deficit. The deficit reduction debate has allowed tax reform proposals to become mainstream and has made tax reform a more likely component of any long-term solution. Starting with the proposals in President Obama’s Deficit Commission Report, the ideas on how to change the Tax Code keep coming, most notably from the so-called “Gang of Six” in the Senate and the House Republican Study Committee. The House Ways and Means Committee and the Senate Finance Committee have also accelerated the momentum toward tax reform legislation, with each conducting recent hearings that considered fundamental changes to the Tax Code.

Administration’s Proposals

President Obama continues to take the official position that any long-term deficit reduction under the two-stage deal

must include revenue increases as well as spending cuts. At the center of President Obama’s plan is an extension of the Bush-era tax cuts for lower and middle income taxpayers after 2012, but not for some higher income taxpayers now in the top two rate brackets. Under the president’s plan, taxes would increase for higher income individuals (which the White House defines as individuals with incomes above \$200,000 and families with incomes above \$250,000). The White House has also called for the elimination of certain oil and gas tax preferences, a permanent research tax credit and an extension of the 2011 payroll tax cut. While initially the administration backed off on its insistence that tax revenues be a part of the immediate deal on the debt ceiling, it seems clear that the president wants his tax proposals to form a part of the bargain brokered within the joint committee.

“Tax proposals from both sides of the aisle as part of the current deficit debate have included bold, sweeping changes.”

COMMENT. *Not discussed during the deficit negotiations, but clearly still on the overall agenda, are two new taxes on higher income individuals effective after 2012: a 0.9 percent additional Medicare tax on wages and self-employment income and a 3.8 percent Medicare contribution tax on unearned income.*

COMMENT. *The future of the federal estate tax has hardly been discussed, at least in public, during the deficit negotiations. The 2010 Tax Relief Act provided higher exemption amounts and lower tax rates, but its relief is temporary and is scheduled to expire after 2012. Like the individual tax rates, debate over the estate tax is virtually guaranteed by sunset provisions that*

require the estate tax to revert to pre-2001 rates and exemptions if no Congressional action is taken. That would mean a rise in the maximum estate tax rate from its current 45 percent to 55 percent and a drop in the maximum estate tax exemption from \$5 million to \$1 million.

Gang of Six Tax Proposals

In early 2011, six members of the Senate began negotiations on a comprehensive deficit reduction plan (Senators Saxby Chambliss, R-Ga., Tom Coburn, R-Okla., Kent Conrad, D-N.D., Mike Crapo, R-Idaho, Dick Durbin, D-Ill., and Mark Warner, D-Va). They came to be known as the “Gang of Six.” On July 19, 2011, the senators released a bipartisan blueprint to reduce the budget deficit by \$3.7 trillion over 10 years through a combination of spending cuts and revenue raisers.

IMPACT. *During the deficit talks, the Gang of Six plan was not ready for prime time because details remained sparse and no legislation had been written. The Gang of Six plan has also yet to be scored by the Congressional Budget Office so its reported savings of \$3.7 trillion over 10 years is merely an estimate at this time. Despite its vagueness, the Gang of Six plan can claim one moniker all the other proposals that have included tax changes cannot. The plan appears to be the only bipartisan plan to address both spending cuts and tax reform. As such, the plan outlined by the Gang of Six likely will form a starting point when the joint committee starts its work. The Gang of Six projects \$1 trillion in revenues from tax reform.*

Individual tax rates. The Gang of Six would replace the current individual marginal income tax rate schedule with three new tax brackets, ranging from: 8-12 percent; 14-22 percent; and 23-29 percent.

COMMENT. *The Gang of Six proposes to maintain or improve the progressivity of the Tax Code but has not provided specifics.*

AMT. The Gang of Six would abolish the alternative minimum tax (AMT). This in large part would be facilitated by the proposed reduction in the regular income tax rates along with pruning back available deductions and credits.

Tax expenditures. The Gang of Six would reduce an unspecified number of tax expenditures that would enable the general reduction in marginal income tax rates.

COMMENT. *Possible tax expenditures up for reform, but not repeal, could include the home mortgage interest deduction, the deduction for charitable contributions and the deduction for certain medical expenses.*

Child tax credit and earned income credit. The Gang of Six would keep the child tax credit and the earned income credit (EIC) but it is unclear whether these provisions would be retained at their present levels.

COMMENT. *The future of the EIC appears to be one of the most contentious issues between the White House and the GOP. President Obama has proposed to extend the EIC as enhanced by legislation enacted in 2001 and subsequent years, which simplified and broadened the EIC. Some lawmakers have proposed to eliminate or scale back the EIC as part of a comprehensive deficit reduction plan.*

Corporate tax. The Gang of Six would establish a single, lower corporate tax rate of somewhere between 23 percent and 29 percent while promising to raise as much revenue as under the current corporate tax system by eliminating many yet-to-be specified business deductions, credits and other preferences. The Gang of Six would also move to a territorial tax system.

IMPACT. *The U.S. tax system is basically a worldwide system whereby companies registered as U.S. domestic companies are subject to taxation on all income regardless of where it is earned. Under a territorial tax system, profits*

are only taxed by the country where the income is earned.

Health care reform. The Gang of Six would abolish the Community Living Assistance Services and Supports (CLASS) program enacted by the Patient Protection and Affordable Care Act (PPACA). The CLASS program, scheduled for creation in 2012, is a voluntary long-term care and disability program.

Inflation adjustments. Many provisions in the Tax Code are adjusted annually for inflation. The Gang of Six would modify how various items are adjusted for inflation using what is known as a “chained-Consumer Price Index (CPI).”

COMMENT. *The “chained CPI” is an alternative Bureau of Labor Statistics index that generally shows a lower inflation rate than the standard calculation. The Joint Committee on Taxation, in a June 29, 2011 report, estimated that middle and lower income taxpayers would be hit hardest by this change, which is projected to bring in \$59 billion in revenue over 10 years. The new index would lower annual adjustments to the regular income tax brackets, the basic and additional standard deductions, the personal exemption amount, the personal exemption and itemized deduction phase-out, the earned income credit, the child credit, the saver’s credit and the IRA contribution limits and deductions.*

Future tax reform. If the proposals put forward by the Gang of Six exceed revenue targets, their plan would call for additional revenue to go to unspecified reductions in the individual marginal income tax rates and deficit reduction.

House Republican Study Committee

The Republican Study Committee (RSC) is made up of 175 conservative members of the House. The RSC drafted the deficit reduction proposal which passed the House on July 19, 2011 as the Cut, Cap and Balance

Major Tax Changes Under Consideration

Major changes to the Tax Code proposed within the course of the most recent deficit debate include:*

INDIVIDUALS:

- Three individual income tax brackets, as low as 8, 14, and 23 percent
- Reduction of favored treatment for capital gains and dividends
- Repeal of the alternative minimum tax (AMT)
- Reduction of key deductions such as for mortgage interest, charitable contributions and medical coverage expenses
- Repeal of deductions for state/local taxes and all miscellaneous itemized deductions

BUSINESSES:

- A single corporate income tax rate, as low as 23 percent
- Reduction in key business deductions/incentives such as the Sec 199 production activity deduction, LIFO and oil/gas benefits
- Switch from a worldwide to a territorial based international tax system

*Selected tax provisions

Act (H.R. 2560). The Cut, Cap and Balance Act, ultimately rejected by the Senate, did not include any tax increases. The RSC has come out in favor of repealing tax increases in the Patient Protection and Affordable Care Act (PPACA) and the Health Care and Education Reconciliation Act (HCERA).

Health care reform. According to the RSC, repeal of the health care reform package would eliminate \$677 billion in additional spending over 10 years. Among the tax provisions in the PPACA and HCERA the RSC proposes to eliminate are the large employer mandate (“play or pay”), the individual responsibility mandate, the excise tax on high-dollar health insurance plans, and more.

COMMENT. *Previous attempts to repeal the PPACA and the HCERA have failed in Congress and future efforts are also likely to fail as long as Democrats maintain control of the Senate.*

Tax reform. The RSC has called for a “smarter” Tax Code that would lower rates while broadening the tax base. The RSC to date has not offered any further specifics on how it would lower rates and broaden the tax base. The RSC has previously indicated its opposition to any scaling back of the Bush-era tax cuts.

White House Deficit Commission

The bipartisan National Commission on Fiscal Responsibility and Reform issued its final report, “The Moment of Truth,” in December 2010. The Commission developed a six-part plan designed to reduce the federal deficit by almost \$4 trillion by 2020. The 18-member commission approved the report by a vote of 11-7, with Democrats and Republicans on both sides of the vote.

IMPACT. *When the Commission issued its report, some Democrats lauded the plan for requiring both tax reforms and spending reforms. Other Democrats called the cuts to Social Security and Medicare “simply unacceptable.” The White House initially issued a guarded assessment, saying that the report “advanced the debate.” Some Republicans expressed concern about the reliance on increases in tax revenue. The report has been used since then to varying degrees to bolster certain positions.*

Spending cuts. The commission’s six-part plan calls for cuts in discretionary and mandatory federal spending, health care savings and reduced health care spending, changes to Social Security and budget process reforms.

Tax reform. Tax reform as envisioned by the Deficit Commission would achieve at

least 20 percent of the \$4 trillion reduction. Tax revenues, which in 2010 were 14.6 percent of gross domestic product, would rise to 21 percent of GDP by 2022. The Deficit Commission plan aims to reduce, if not eliminate, \$1.1 trillion in tax expenditures in the current Tax Code for individuals and businesses. Under current law, the largest tax expenditure is the tax-free treatment of contributions to health care plans at approximately \$144 billion per year.

Other substantial tax expenditures include:

- \$79 billion for home mortgage interest,
- \$57 billion for accelerated depreciation,
- \$53 billion for capital gains, and
- \$49 billion for the earned income credit.

At the same time, the plan would reduce tax rates, the amount depending on the amount of tax expenditures eliminated.

IMPACT. *There are over 150 tax expenditures, including 75 involving business taxes, according to the Deficit Commission. Its plan would eliminate nearly all of them, but with a gradual phase-in period for many of the more popular among them such as the home mortgage interest deduction.*

Individual income tax rates. Under one scenario, the Deficit Commission’s plan would provide three ordinary income tax rates as low as 8, 14, and 23 percent. The plan would treat capital gains and dividends as ordinary income, but, of course, ordinary income rates would be lower. The plan would eliminate the alternative minimum tax (AMT).

More reforms. Other targeted reforms proposed by the Deficit Commission include:

- Limiting the charitable deduction for individuals to amounts over two percent of adjusted gross income;
- Repealing the state and local tax deduction for individuals;
- Repealing all miscellaneous itemized deductions for individuals;

Looming Expiration of Extended Bush-Era Tax Cuts

If Bush-era tax cuts are not extended beyond 2012:*

- Individual income tax rates revert to 15, 28, 31, 36, 39.6 percent
- Pease limitation returns in full
- Personal exemption phaseout (PEP) returns in full
- Increased taxes on capital gains and dividends
- Estate tax reverts to a maximum tax rate of 55 percent

*Selected tax provisions

- Capping the income tax exclusion for employer-provided health insurance; and
- Raising the federal gasoline tax by 15 cents per gallon.

Corporate tax. The Deficit Commission plan would provide a single corporate tax rate of 26 percent, compared to the current maximum rate of 35 percent. Additional business-related reforms include eliminating the Code Sec. 199 deduction, the LIFO (last-in, first-out) method of accounting, and oil and gas production incentives.

TAX WRITING COMMITTEES

While the White House and Congressional leaders have been negotiating a deficit reduction plan, the tax writing committees in Congress are exploring possible reforms to the Tax Code. The Senate Finance Committee, controlled by Democrats, and the House Ways and Means Committee, controlled by Republicans, have looked at a variety of issues related to individual and business taxation.

COMMENT. *Rather than engage in a debate over whether certain provisions raise or lower taxes, changes made under the general banner of tax reform can have the advantage of gaining support from both*

ends of the political spectrum. Overall tax reform proposals as a whole likely will be given the mandate to be revenue neutral. Nevertheless, specific measures within such legislation would not necessarily follow that guideline. As a result, certain “winners and losers” under tax reform will be inevitable.

Senate Finance Committee

The Senate Finance Committee (SFC), under the leadership of Sen. Max Baucus, D-Mont., has held a series of hearings in recent months on tax reform. The SFC has examined, among other issues, oil and gas tax preferences, the tax treatment of business and household debt, strategies to in-

crease the voluntary compliance rate to 90 percent, and efforts to close the tax gap.

COMMENT. *The SFC has not yet presented any comprehensive tax reform legislation to the Senate. Smaller and more targeted bills have been introduced, such as legislation to extend the Work Opportunity Tax Credit (WOTC) to recently discharged veterans of the U.S. armed forces. A majority of the SFC had supported the elimination of enhanced information reporting requirements for businesses and landlords, which Congress ultimately passed in the Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011 (P.L. 112-9).*

House Ways and Means Committee

The House Ways and Means Committee has also held a series of hearings on tax reform in recent months. The Ways and Means Committee has examined, among other issues, the advantages and disadvantages of a value added tax (VAT), tax incentives to encourage foreign investment in the U.S., and the corporate tax rate.

COMMENT. *Like the SFC, the Ways and Means Committee has not presented any comprehensive tax reform legislation to the House. The current expectation is that at least preliminary bill language would be available by year end 2011. ♦*



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