



# Post-Election Legislative Outlook, Including the Prospects for Tax Reform

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# Lame-Duck Legislative Outlook

# Year-end tax landscape uncertain

## Scheduled tax increases

- ▶ 2001/2003 tax relief expires on 12/31/12
- ▶ Alternative minimum tax (AMT) patch needed for 2012
- ▶ Expired and expiring tax extenders
- ▶ Payroll tax relief expires on 12/31/12
- ▶ New Medicare taxes in 2013

## Economic and fiscal backdrop

- ▶ Slow economic recovery
- ▶ Growing U.S. federal debt and deficits
- ▶ Expanded unemployment benefits expire on 12/31/12
- ▶ Medicare physician payment rate falls on 12/31/12
- ▶ Sequestration under Budget Control Act of 2011 (BCA) in 2013
- ▶ Federal debt ceiling needs to be increased

## Political backdrop

- ▶ Election maintains status quo
- ▶ Lame-duck session

# Expiration of the 2001/2003 tax relief

- 2001/2003 tax relief expires at the end of 2012
  - ▶ Highest marginal income tax rates will rise to 36% and 39.6% from 33% and 35%
  - ▶ 10% rate bracket will be eliminated
  - ▶ Maximum rate on qualified dividends will rise from 15% to 39.6% (plus 3.8% Medicare tax for taxpayers with income above \$250,000)
  - ▶ Maximum rate on long-term capital gains will rise from 15% to 20% (plus 3.8% Medicare tax for taxpayers with income above \$250,000)
  - ▶ Phaseouts of itemized deductions and personal exemptions will be reinstated for high-income individuals
  - ▶ Marriage penalty relief will expire
  - ▶ Child tax credit will decline from \$1,000 to \$500
  - ▶ Maximum estate tax rate will rise from 35% to 55%, and exemption will fall from \$5 million to \$1 million

# Expiring 2001/2003 tax relief: scheduled 2013 individual tax rates

Description	Current rates	Scheduled rates for 2013	Other additions
<b>Individual income tax rates</b>	10%; 25%; 28%; 33%; 35%	15%; 28%; 31%; 36%; 39.6%  Reinstate personal exemption phase-out (PEP) and Pease limitation on itemized deductions	Individuals with income over \$250,000 (joint) or \$200,000 (individual) face Medicare tax increases of: <ul style="list-style-type: none"> <li>▶ 0.9% on wages (on amounts exceeding threshold) <b>and</b></li> <li>▶ 3.8% on the lesser of: <ul style="list-style-type: none"> <li>▶ Net investment income (e.g., interest, dividends, capital gains) <b>or</b></li> <li>▶ Excess of modified AGI on amounts over the \$250,000/\$200,000 threshold</li> </ul> </li> </ul>
<b>Qualified dividends</b>	0%; 15%	Individual income tax rate, with top rate of 39.6%	
<b>Long-term capital gains</b>	0%; 15%	20%	
<b>Estate tax</b>	35% top rate; \$5 million exemption	55% top rate; \$1 million exemption	

# AMT patch

- Without Congressional action, alternative minimum tax will affect an additional 27 million taxpayers in tax year 2012
  - AMT was originally designed to prevent high-income taxpayers from using exclusions, deductions and credits to minimize tax liability
  - AMT is not indexed for inflation, but legislative patches have prevented its expansion to middle-income taxpayers
  - Most recent AMT patch expired December 31, 2011
  - CBO estimates permanently extending the AMT patch and indexing it for inflation would increase annual deficits by \$937 billion from FY 2013–2022

# Fate of tax extenders uncertain

More than 60 business and individual tax extenders expired December 31, 2011. In prior years, tax extenders were generally passed as a package or, if allowed to expire, retroactively reinstated.

Current political and economic environment complicates prospects for extending these provisions

- ▶ Difficult to pass tax provisions without identifying revenue offsets
- ▶ Increased scrutiny of provisions
- ▶ Desire to evaluate provisions as part of fundamental tax reform

Limited vehicles before year-end to move proposals

- ▶ Legislation during the lame-duck session?

Some extenders may be addressed in piecemeal fashion

***No guarantee that extenders will pass or be retroactively reinstated this year***

# Sequestration: spending cuts

- Due to the 2011 failure of the Joint Select Committee on Deficit Reduction to agree on a deficit reduction plan, the BCA mandated \$1.2 trillion of scheduled savings through an automatic spending cut process (sequestration)
  - The BCA resulted in an initial \$917 billion in deficit reduction from discretionary spending caps for FY 2012—2021
  - Sequestration is scheduled to begin in January 2013
  - Sequestration will be divided evenly between defense and non-defense spending
    - House of Representatives recently passed a bill to replace the sequester and generally protect defense spending; Senate and Administration are opposed to the House bill
  - If Congress cannot agree on an alternative \$1.2 trillion in spending cuts or added revenue over the next 10 years, sequestration will go into effect

# Prospects for Tax Reform

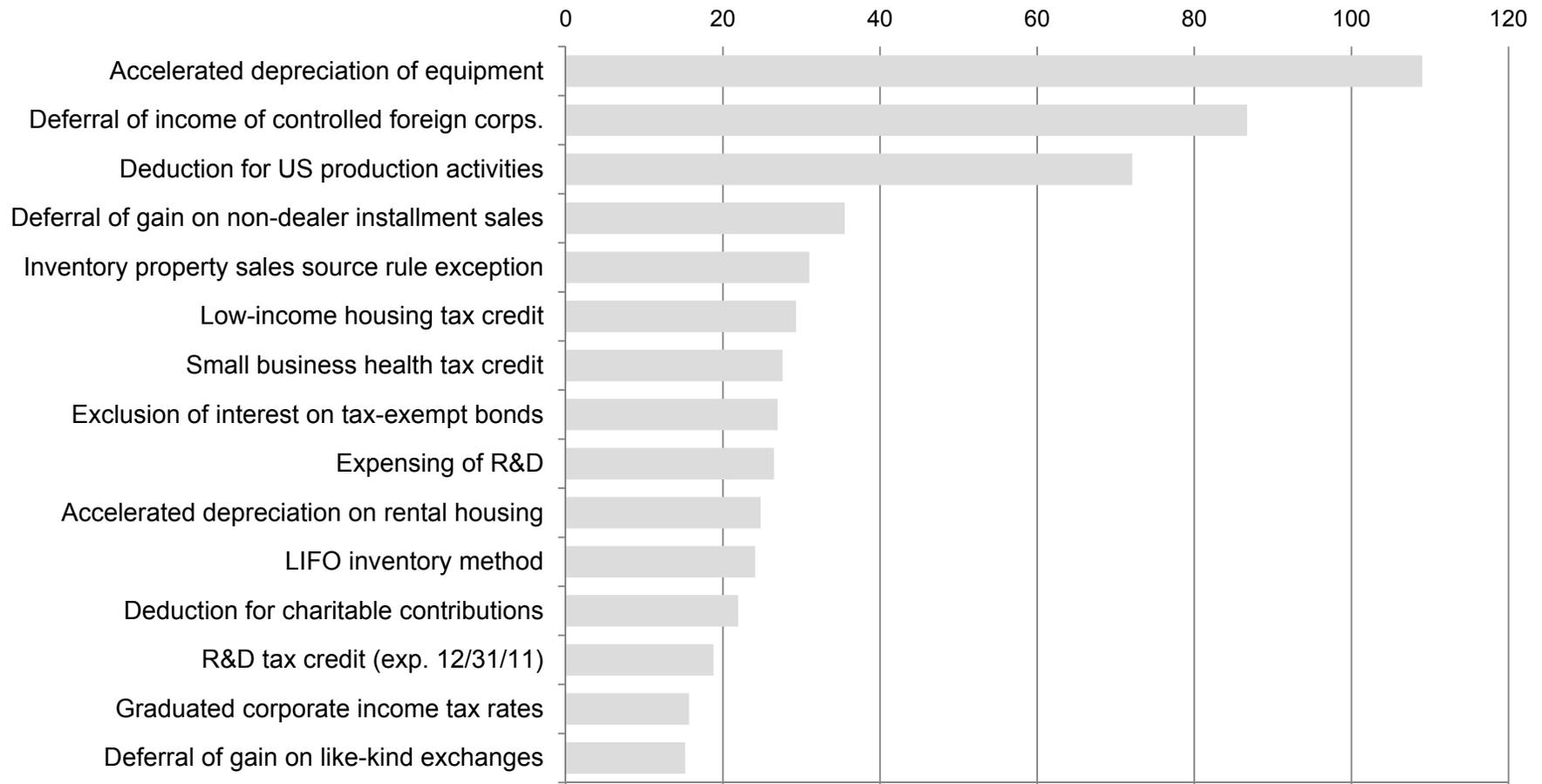
# Drivers for Tax Reform

- Instability and complexity
  - Uncertainty hampers planning and investment
  - Simplification will lessen the role of tax in decision-making
- Competitiveness: The United States has one of the highest statutory corporate income tax rates in the world. Unlike most other countries, the United States does not have a territorial system of taxing foreign earnings.
- Will tax reform be used to raise revenues as part of a solution to address U.S. budget deficits?

# Common assumptions in some corporate tax reform proposals

- Lower corporate tax rate
- Broader corporate tax base
- Shift from a worldwide system toward a territorial system?
- Need for anti-base erosion provisions
- Revenue neutrality (however defined)
- Changes within the current income tax system (no VAT)

# Top 15 business tax expenditures, FY2011-2015 \$ Billions



Note: Includes only permanent, positive tax expenditures. The value of the tax expenditure for tax-exempt bonds includes only the benefit to the corporate investors, not the benefit of lower interest rates to the issuers. Totals may not add due to rounding.

Source: Joint Committee on Taxation and Ernst & Young LLP, calculations.

# Business tax reform proposals

## Obama business tax reform framework

- ▶ Details left to Congress, reflects past budget proposals
- ▶ 28% corporate rate (25% for manufacturing)
- ▶ Minimum tax on foreign profits
- ▶ Retention of worldwide system

## Camp international discussion draft

- ▶ 25% corporate tax rate
- ▶ Shift toward territorial system for foreign earnings
- ▶ No individual taxpayer provisions

## Senator Enzi international reform bill

- ▶ Shift toward territorial system for foreign earnings

## Senator Portman plan possible at some point

- ▶ Revenue-neutral corporate reform plan with 25% rate/territorial system
- ▶ Base broadeners may be set forth

# The President's Framework for Business Tax Reform

## Broaden base to cut corporate tax rate

- ▶ 28% corporate rate
- ▶ No comprehensive list of provisions to be eliminated, but a few are highlighted:
  - ▶ LIFO, oil/gas, carried interest, jet depreciation
- ▶ Depreciation, deductibility of interest, treatment of large non-corporate entities also should be considered

## Manufacturing incentives

- ▶ Reduce effective rate for manufacturers to 25% by refocusing section 199 manufacturing deduction
  - ▶ Further reduction in rate for advanced manufacturing
- ▶ Permanent R&D credit
- ▶ Energy incentives

## International tax

- ▶ Starts from current worldwide system of taxing foreign earnings
- ▶ Comes out against *pure* territorial system
- ▶ U.S. corporations to pay an unspecified minimum tax on foreign earnings
- ▶ Proposals for excess intangible returns, interest deductions attributable to foreign earnings

## Small business

- ▶ Make tax filing simpler
- ▶ Allow expensing up to \$1 million in investments
- ▶ Allow cash accounting for businesses with up to \$10 million in gross receipts

## Fiscal responsibility

- ▶ Business framework revenue-neutral, \$250 billion extra required to make permanent temporary provisions that are routinely extended
- ▶ \$1.5 trillion new net revenue from individual tax reform

# International tax reform plans

Ways and Means Committee Chairman Camp, *international discussion draft*,  
October 26, 2011

- ▶ 95% deduction for the foreign-source portion of dividends received from CFCs
- ▶ Imposition of a 5.25% tax rate on pre-effective date foreign earnings
- ▶ Proposals for the prevention of base erosion, including specific options relating to the treatment of intangibles income



Senator Enzi, *United States Job Creation and International Tax Reform Act of 2012 (S. 2091)*

- ▶ 95% dividend exemption, applicable to post-2012 undistributed foreign earnings
- ▶ Proposes significant reforms to Subpart F
- ▶ Elective transition into the participation system for pre-effective date foreign earnings
- ▶ Anti-base erosion proposal
- ▶ Does not include a reduction in the corporate tax rate

Obama Administration, *President's Framework for Business Tax Reform*

"The Administration believes that a pure territorial system could aggravate, rather than ameliorate, many of the problems in the current tax code. If foreign earnings of U.S. multinational corporations are not taxed at all, these firms would have even greater incentives to locate operations abroad or use accounting mechanisms to shift profits out of the United States. Furthermore, such a system could exacerbate the continuing race to the bottom in international tax rates."



# Political trade-offs in business tax reform debate

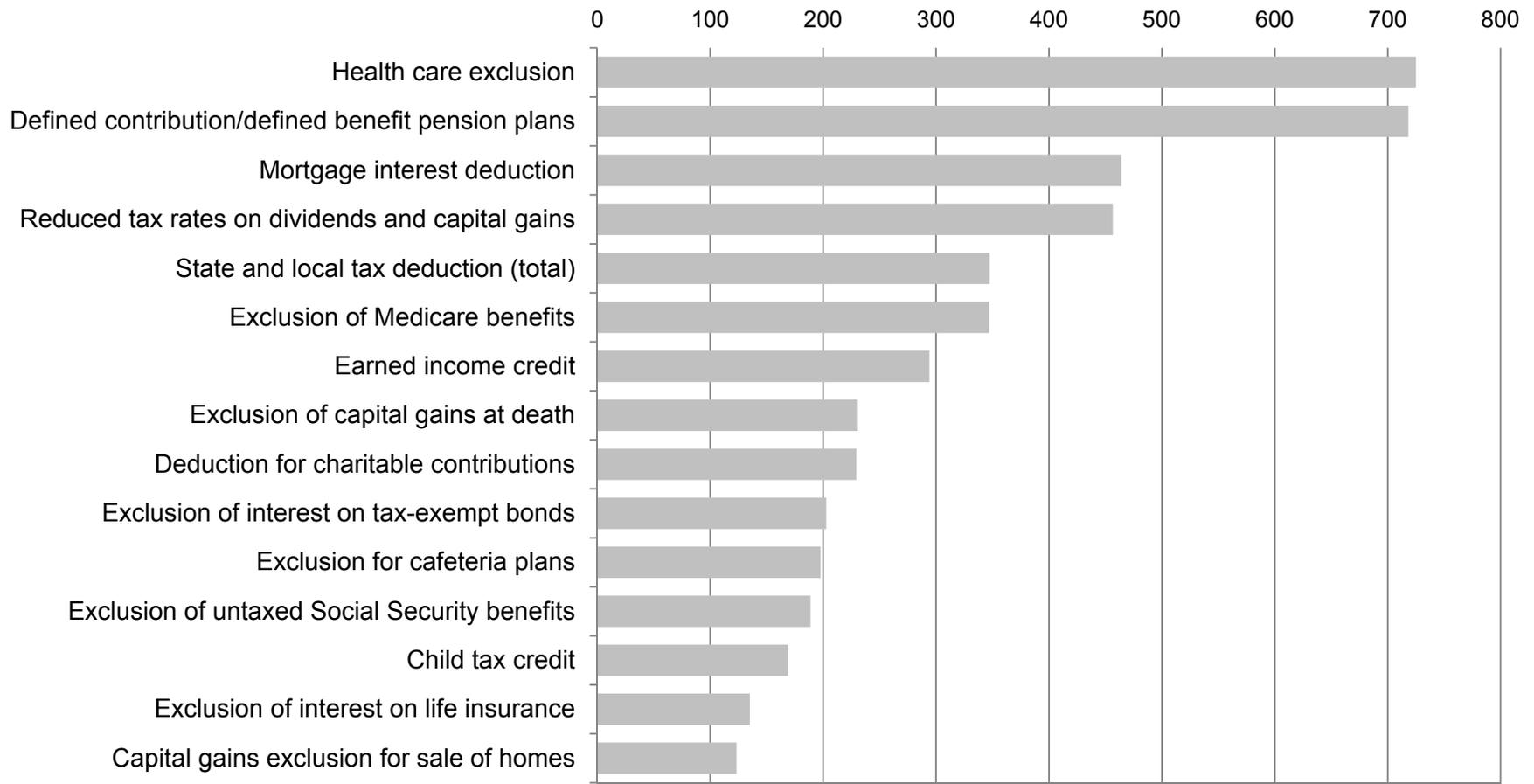
- Corporate vs. pass-through entities
- Corporate-only base broadeners vs. business base broadeners
- Multinational interests vs. domestic interests
- Capital intensive businesses vs. service businesses
- Industry vs. industry
- Historic vs. new entities within the same industry
- Specific tax incentives vs. rate reduction
- Transition relief vs. immediate change

# Tax Reform for Individuals

- No tax reform proposals regarding individuals have been put forward
- Broadening the tax base and lowering rates are traditionally the twin goals
- What does meaningful broadening of the income tax base entail?
  - Employer-provided health care exclusion?
  - Mortgage interest deduction?
  - Charitable deduction?
- Converting major deductions to credits may increase progressivity and could be designed to raise revenue

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\$ Billions



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## Tax Reform for Individuals (continued)

- What is the appropriate top marginal income tax rate?
  - What are the appropriate capital gains and dividend tax rates?
- Owners of pass-through entities (partnerships, LLCs and S corporations) and sole proprietorships pay tax at individual income tax rates
- How will tax reform address the alternative minimum tax?
- Can tax reform reduce the tax gap?

# Effects of Tax Reform on Pass-Through Entities?

- Higher tax rates on owners of pass-through entities and sole proprietorships?
- Carried interest
- Obama Administration suggestion to tax large pass-through entities as corporations
- Eliminate business tax expenditures without reducing the tax rate on owners of pass-through entities?