

WHITE HOUSE TAX AND DEFICIT REDUCTION PROPOSALS

September 22, 2011

Special Report

HIGHLIGHTS

- Repeal Of Bush-Era Tax Cuts For Higher Income Taxpayers
- Buffett Rule
- Return Estate Tax To 2009 Levels
- Elimination Of Oil, Gas And Coal Preferences
- LIFO Repeal
- Permanent FUTA Surtax Extension
- International Tax Reforms

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Obama Aims For \$1.5 Trillion In New Tax Revenue To Reduce Deficit

President Obama unveiled a \$3 trillion federal budget Deficit Reduction Plan on September 19, 2011 including \$1.5 trillion in tax increases. The President's Deficit Reduction Plan ("Living Within Our Means and Investing in the Future: The President's Plan For Economic Growth and Deficit Reduction") makes good on his pledge to produce a balanced deficit reduction package, one that combines spending cuts with revenue raisers. Increased taxes on higher income individuals would account for a significant portion of the revenue raised under the President's Deficit Reduction Plan. Other areas targeted for tax hikes include the oil, gas and coal industries, certain international activities and more.

IMPACT. *One proposal that sparked immediate interest and criticism – the so-called Buffett Rule – was left undefined in the President's Deficit Reduction Plan released on September 19. The White House has deflected requests to define the Buffett Rule beyond a general explanation that the rule is intended to ensure that households making over \$1 million do not pay a smaller share of income than middle income taxpayers.*

The White House expects opposition from the GOP to its tax proposals but some Democrats in Congress have also voiced concerns about limiting deductions for higher income taxpayers and raising taxes during an economic slowdown. Consensus is that compromise is necessary; the issue, however, is the extent to which President Obama considers his proposals already represent a compromise and how much further he is willing to go before using his veto pen.

OVERVIEW

Tax provisions play a leading role in the President's Deficit Reduction Plan. These tax provisions can be further divided into five subparts:

- A call for comprehensive tax reform, both for individuals and corporations, in which lower tax rates, the removal of inefficient and unfair tax breaks and reform of an overly complex Tax Code are general goals but without specific proposals;
- A tax structure starting in 2013 that ends the Bush-era tax cuts for higher income individuals, as well as introducing the so-called "Buffett Rule;"
- Incorporation of the provisions in the American Jobs Act, as proposed by President Obama on September 12, 2011 (see the CCH Tax Briefing: American Jobs Act on CCH's IntelliConnect and CCH's Tax Research Network);
- Incorporation of targeted business-directed loophole closers as proposed in President Obama's fiscal year (FY) 2012 Budget Proposals released in February 2011;
- A handful of tax-related measures that fit within President Obama's Deficit Reduction Plan calling for mandatory savings within health care and other government programs.

HIGHER INCOME TAXPAYERS

A number of proposals in the President's Deficit Reduction Plan would increase the tax obligations of higher-income taxpayers starting in 2013:

Individual Income Tax Rates

President Obama's Deficit Reduction Plan would not extend the Bush-era individual marginal income tax rates for higher-income taxpayers. Under current law, the top two rates will revert to 36 and 39.6 percent, respectively after December 31, 2012 if Congress does nothing. The President's Deficit Reduction Plan would let the top two rates revert for "higher income taxpayers."

COMMENT: *The White House defines higher-income taxpayers for purposes of the Bush-era tax cuts as individuals with incomes over \$200,000 and married couples filing a joint return with incomes over \$250,000 (as adjusted for inflation since 2009).*

IMPACT. *By inference (but not directly recommended under the President's Deficit Reduction Plan), the current 10, 15, 25, and 28 percent rates would be extended permanently.*

IMPACT. *The President's Plan divides higher-income individuals into two groups: (1) individuals above the \$200,000/\$250,000 level for purposes of applying the higher income tax brackets and (2) individuals with incomes over \$1 million who are deemed higher income taxpayers for purposes of applying the Buffett Rule.*

COMMENT: *After 2012, two additional, already enacted, tax increases are scheduled to impact higher income taxpayers: an additional 0.9 percent Medicare tax on wages and self-employment income and a 3.8 percent Medicare tax on unearned income.*

Capital Gains/Dividends

Current law taxes capital gains and qualified dividends at 15 percent for taxpayers in tax rate brackets above 15 percent (and at zero percent for all other taxpayers). This taxpayer-friendly treatment of capital gains and qualified dividends is scheduled to expire after December 31, 2012.

IMPACT. *President Obama's fiscal year (FY) 2012 federal budget recommends taxing capital gains and qualified dividends at 20 percent for married couples with incomes over \$250,000 and individual taxpayers with incomes at \$200,000. All other taxpayers would be taxed at the rates in effect for 2012. The President's Deficit Reduction Plan is less specific and merely calls for repeal of the Bush-era tax cuts for higher-income taxpayers after 2012.*

"Increased taxes on higher income individuals would account for a significant portion of the revenue raised under the President's Deficit Reduction Plan."

COMMENT: *For hedge-fund managers, the increase in the capital gains rate to 20 percent would not replace the additional proposal in the American Jobs Act portion of the President's Plan to tax carried interest at ordinary income rates.*

Limitation on Deductions

President Obama's Deficit Reduction Plan (and his proposed American Jobs Act) would limit the tax rate at which higher income taxpayers can take itemized deductions and certain above-the-line deductions and exclusions, to a maximum of 28 percent. The limit would apply to all itemized deductions, foreign excluded income, tax-exempt interest, employer sponsored health insurance, and selected above-the-line deductions.

IMPACT. *As with the higher marginal tax rates, President Obama defines higher income taxpayers for purposes of the proposed limitation on deductions as individual taxpayers with incomes over an*

inflation-adjusted \$200,000 and married couples filing a joint return with incomes over \$250,000. Unlike the so-called "Pease" limitation on itemized deductions and the limitation on personal exemptions that are on the books to return in 2013 after being suspended for the 2010-2012 period, the President's Deficit Reduction Plan goes beyond targeting selected itemized deductions and limits benefits beyond those reduced under the Pease limitation.

IMPACT. *Just limiting the tax rate at which higher-income individuals can take itemized deductions and tax preferences to a maximum of 28 percent is estimated to bring in \$410 billion in revenue. Similar Administration proposals were rejected by Congress in 2009 and 2010.*

The Buffett Rule

According to the White House, no household making over \$1 million annually should pay a smaller share of its income in taxes than middle-income families. To ameliorate the problem, President Obama has proposed what he calls the Buffett Rule as part of an overall reform package that increases the progressivity of the Tax Code. The Buffett Rule is named after billionaire investor Warren Buffett who recently pointed out that he should not be paying taxes at a lower rate than his secretary.

COMMENT: *When asked to explain the Buffett Rule at a news conference on September 19, Treasury Secretary Timothy Geithner said that there are many different ways to achieve the Buffett Rule and the Administration would defer to Congress to decide how to implement the rule. "The basic principle at the heart of the Buffett Rule is that if you are among those fortunate few in the United States, you should pay as a share of income in taxes more than what a middle-class family pays," Geithner said.*

COMMENT: *The alternative minimum tax (AMT) was originally enacted to ensure that wealthy taxpayers did not evade*

taxation. President Obama did not specifically address the AMT in his Deficit Reduction Plan. The AMT was most recently “patched” (to prevent encroachment on middle income taxpayers) in the 2010 Tax Relief Act, which temporarily extended higher exemption amounts and other relief. That extension is scheduled to expire at the end of 2011.

Estate Tax

The 2010 Tax Relief Act revived the federal estate tax for decedents dying after December 31, 2009, and allowed estates of decedents dying after December 31, 2009, and before January 1, 2011, to elect a carryover basis regime instead of the step-up basis required by the revived estate tax rules. President Obama’s Deficit Reduction Plan would return the estate tax to its 2009 parameters.

IMPACT. In 2009, the maximum federal estate tax rate was 45 percent and the exemption level was \$3.5 million. For 2011 and 2012, the estate tax rate is 35 percent and the unified estate and gift tax exclusion is \$5 million for 2011 and an inflation-adjusted \$5.120 million projected for 2012.

COMMENT: For 2009, the gift tax lifetime exclusion was \$1 million. It is uncertain whether the President’s Deficit Reduction Plan would unify the exclusion at \$3.5 million for both estate and gift tax purposes. For 2012, a donor’s inflation-adjusted annual gift tax exemption amount per donee is projected to be \$13,000 (\$26,000 for split gifts), the same level it has been since 2009. No proposal has been made to change that regime.

AMERICAN JOBS ACT PROPOSALS

The President’s Deficit Reduction Plan incorporates as an integral part of its strategy the proposed American Jobs Act, which was unveiled by the Administration on Septem-

ber 12, 2011. The \$447 billion jobs package includes among its tax provisions:

- Payroll tax cuts for employees and the self-employed;
- Payroll tax cuts and tax credits for employers to encourage hiring; and
- 100 percent bonus depreciation extended through 2012 to stimulate capital investment.

On the revenue raising side, the American Jobs Act would:

- Tax as ordinary income carried interest paid to investment fund managers;
- Eliminate favorable depreciation rules for corporate jets;
- End a variety of tax incentives for oil and gas producers; and
- Shut down abusive foreign tax credit strategies by “dual capacity” taxpayers and other businesses.

For further details on the tax proposals within the American Jobs Act of 2011, see the *CCH Tax Briefing: American Jobs Act of 2011* on CCH’s IntelliConnect and CCH’s Tax Research Network.

BUSINESSES

President Obama’s Deficit Reduction Plan briefly mentions some popular corporate tax incentives, such as the research tax

credit, but leaves their fate to Congress with a call for comprehensive and deficit neutral tax reform. Deficit neutral tax reform, the president stressed, would make business taxpayers pay for business tax incentives that generally have been deficit financed in the past.

IMPACT. A host of temporary business tax incentives (“tax extenders”) are scheduled to expire after 2011. They include, but are not limited to, the research tax credit, brownfields remediation, the Indian employment credit, and more. Stand-alone legislation has been introduced in Congress to extend some of the expiring provisions.

COMMENT: President Obama has previously urged Congress to make the research tax credit permanent and enhance the rate of the alternative simplified credit. Ten-year projected cost estimates for a permanent extension, however, weigh in at around \$100 billion, making a permanent extension a decision that Congress may find too costly at this time.

Corporate Tax Rate

In 2010, President Obama signaled his support for a reduction in the corporate tax rate in exchange for the closing of unspecified corporate tax loopholes. The President’s Deficit Reduction Plan does not propose specific corporate tax rates but leaves the rate

PRINCIPLES FOR TAX REFORM

President Obama outlined five principles for tax reform in his deficit reduction plan:

1. Lower tax rates (for individuals and corporations) with fewer brackets
2. Cut inefficient and unfair tax breaks
3. Cut the deficit by \$1.5 trillion over the next decade through tax reform
4. Increase job creation and growth
5. Observe the Buffett Rule

structure for Congress to decide as part of comprehensive tax reform.

COMMENT: *Three factors may play into the viability of corporate tax rate reform:*

(1) *Consensus that the existing rate structure encourages many corporations to move their operations offshore;*

(2) *Estimates that the effective tax rate on corporations can vary markedly from zero to 35 percent; and*

(3) *The realization that if tax reform is to be undertaken, it may be prudent to address corporate tax reform before taking on the likely more difficult issue of tax reform for individuals.*

COMMENT: *The President's Deficit Reduction Plan also includes some significant new fees. Airline passengers, military retirees and others are just some of the taxpayers that would be impacted by new or enhanced fees.*

Oil, Gas and Coal Preferences

President Obama's Deficit Reduction Plan would eliminate a number of oil and gas tax preferences. Targeted for repeal under the president's plan are percentage depletion for oil and gas wells, the Code Sec. 199 domestic production activities deduction against income derived from oil and gas production, expensing of intangible drilling costs, deduction for tertiary injectants, the exception to passive loss limitations provided to working interests in oil and natural gas properties, and two-year amortization of independent producers' geological and geophysical expenses.

COMMENT: *Repeal of certain oil and gas tax preferences are some of the revenue raisers in the President's proposed American Jobs Act. The President's Deficit Reduction Plan goes further and proposes to repeal certain tax preferences for the coal industry.*

The coal industry tax preferences targeted for repeal are expensing of exploration and

development costs; percentage depletion for hard mineral fossil fuels; capital gains treatment for coal and lignite royalties; and the Code Sec. 199 domestic production activities deduction for income derived from the production of coal and other hard mineral fossil fuels.

COMMENT: *In 2009, President Obama agreed at the G-20 Summit to phase out subsidies for fossil fuels. According to the White House, phasing out subsidies for fossil fuels will help the country transition to a 21st century energy economy.*

COMMENT: *President Obama also proposed to institute a fee on non-producing oil and gas leases on federal lands and waterways.*

Accounting Methods

President Obama's Deficit Reduction Plan would repeal two accounting methods: the last-in, first-out (LIFO) method and the lower-of-cost-or-market inventory method.

LIFO. Under the LIFO method, the most recently acquired (or manufactured) goods are treated as being sold during the year. President Obama has proposed to repeal the use of LIFO for federal income tax purposes for tax years beginning after December 31, 2012.

IMPACT. *Taxpayers currently using the LIFO method would also be required to write up their beginning LIFO inventory to its first-in, first-out (FIFO) value in the year of change. This one-time increase in gross income would be taken into account ratably over 10 years.*

IMPACT. *Certain industries may be more negatively impacted by LIFO repeal than others; for example, industries with high-volume, high-value products. LIFO repeal would also eliminate a long-standing accounting method that has been recognized since the 1930s.*

Lower-of-cost-or-market inventory. Unless a taxpayer is using LIFO, ending inven-

tory may be written down to a lower market value, and damaged or obsolete goods may be written down to realizable prices less costs of disposition. The determination of lower of cost or market (LCM) must be applied to each item of inventory. President Obama's Deficit Reduction Plan would prohibit the use of the LCM and subnormal goods methods of inventory accounting, effective for the first tax year beginning after December 31, 2012. Any resulting income inclusion would be recognized over a four-year period.

FUTA Surtax

In 1976, Congress enacted a temporary 0.2 percent Federal Unemployment Tax Act (FUTA) surtax. Congress had regularly extended the surtax in subsequent years, but the most recent extension expired after June 30, 2011. President Obama's Deficit Reduction Plan would make the FUTA surtax permanent, retroactive to periods after June 30, 2011.

COMMENT: *The IRS previously indicated it would provide guidance to employers on how to take into account the mid-year expiration of the FUTA surtax. To date, the IRS has not provided that guidance.*

COMMENT: *In his FY2012 federal budget proposal, President Obama called for increasing the FUTA taxable wage base (\$7,000 for 2011) to \$15,000, starting in 2014 and indexing it for inflation thereafter. The President's Deficit Reduction Plan would also raise the FUTA wage base in 2014 to \$15,000, along with indexing it to average wages. At the same time, the President proposed to reduce the overall FUTA tax rate to an unspecified percentage if the wage base is increased.*

Worker Classification

President Obama's Deficit Reduction Plan would authorize the IRS to issue general guidance on worker classification, authority the IRS has lacked since 1978. Additionally, the President has proposed to grant the IRS

the authority to require prospective reclassification of workers who cannot be reclassified under current law.

IMPACT. *Employers with a small number of employees and a small number of misclassified workers, that consistently filed all returns reporting all misclassified workers and that agreed to prospective reclassification of misclassified workers, would be eligible for waiver of penalties for misclassifications. However, the President's Deficit Reduction Plan does not define "small" for this purpose.*

IMPACT. *The President's proposal predicts that IRS enforcement action would focus on prospective worker classification.*

COMMENT: *The IRS and the U.S. Department of Labor (DOL) signed a memorandum of understanding (MOU) on September 19, 2011, agreeing to more exchanges of information about worker classification. On September 21, 2011, the IRS announced a new Voluntary Classification Settlement Program.*

Health Care Provisions

In recognition of high health care costs that continue to drive long-term deficits, the President's Deficit Reduction Plan proposes two tax-related provisions within its Health Savings recommendations:

- A reduction in federal Medicaid matching to states by phasing down the Medicare provider tax threshold, beginning in 2015; and
- Amendment of modified adjusted gross income for health insurance assistance programs to include the total amount of Social Security benefits, rather than just the taxable portion, when determining eligibility for Health Insurance Exchange tax credits and cost sharing reductions, Medicaid, and CHIP.

Superfund Taxes

Hazardous Substance Superfund taxes to pay for cleanup of hazardous waste sites ex-

pired after 1995. President Obama's Deficit Reduction Plan would reinstate Superfund excise taxes on oil, petroleum products, hazardous chemicals, and substances used to produce hazardous chemicals for periods (excise taxes) or tax years (income taxes) beginning after 2012, with expiration for periods and tax years after 2021.

Insurance Companies and Products

President Obama's Deficit Reduction Plan includes certain reforms to the taxation of insurance companies and insurance products. The President would expand information reporting on the sale of life insurance contracts and the payment of death benefits on contracts that were sold, modify the rules for sales of life insurance contracts, modify the dividends-received deduction (DRD) for life insurance company separate accounts, and expand the pro rata interest expense disallowance for corporate-owned life insurance (COLI).

IRS OPERATIONS

Enforcement. President Obama has proposed to allocate additional funding for IRS enforcement. The President predicts that the enforcement dollars will deliver \$3.2 billion in deficit reduction over 10 years.

Levies. The President's Deficit Reduction Plan would increase IRS levy authority to 100 percent for federal contractor payments and Medicare payments.

Refunds. Under the President's Deficit Reduction Plan, the IRS would be authorized to offset federal tax refunds to collect delinquent state tax liabilities regardless of where the debtor resides.

Cell phone contact. The President's Deficit Reduction Plan would authorize the IRS to contact debtors by cell phone, which recognizes the growing number of taxpayers who use a cell phone as their primary phone.

INTERNATIONAL REFORMS

President Obama's Deficit Reduction Plan incorporates several proposals from his FY 2012 budget recommendations that would increase taxes on multinational corporations. The President also included some of these items in his proposed American Jobs Act. While the Administration has indicated an interest in international tax reform, these proposals do not reflect an overhaul of the foreign tax system.

IMPACT. *At \$113 billion, the international reforms are important revenue raisers in the President's Deficit Reduction Plan. They are primarily directed toward reducing incentives to shift income and assets overseas.*

Deferred Interest

U.S. businesses can currently deduct interest they pay on debt incurred to finance overseas investments even though U.S. tax on the investment income may be deferred.

SELECTED REVENUE PROVISIONS*

Expiration of Bush-Era Tax Cuts For Higher Incomes and Estate Tax at 2009 Parameters:	\$866 billion
Limitation on Deductions/Tax Preferences for High Incomes:	\$410 billion
International Tax Reforms:	\$113 billion
Repeal Last-In, First-Out (LIFO) Accounting Method:	\$52 billion
Reinstate Superfund Taxes:	\$19 billion
Permanent FUTA Surtax	\$15 billion

*Source: White House, September 19, 2011

Under the President's Deficit Reduction Plan, the deduction of such interest would be deferred, to the extent that the U.S. taxation of the income is deferred. The interest would be allowed in subsequent years in proportion to the amount of the taxpayer's previously deferred foreign-source income that is subject to U.S. tax.

IMPACT. *The proposal would provide greater matching of the interest expense deductions and recognition of the associated income. The Administration estimates that the proposal would reduce the deficit by \$36 billion over 10 years. The President's FY 2012 budget recommendations, which contained a similar proposal, would also empower the IRS to issue regulations and recommend further legislation if necessary to prevent inappropriate decreases in the amount of interest expense allocated and apportioned to foreign-source income.*

FTC Pooling

The President's Deficit Reduction Plan proposes to prevent cross-crediting techniques by requiring a U.S. taxpayer to determine its deemed-paid foreign tax credit (FTC) from dividends received from a foreign subsidiary on a consolidated basis for all its foreign subsidiaries. Foreign tax credits from the receipt of a dividend would be based on the consolidated earnings and profits and foreign taxes of all the taxpayer's foreign subsidiaries.

IMPACT. *Cross-crediting was enhanced when the American Jobs Creation Act of 2004 reduced the FTC limitation "baskets" to two: passive income and general category income. President Obama has proposed to close what is perceived as a loophole caused by that change. The Administration esti-*

mates that the proposal would reduce the deficit by \$53 billion over 10 years.

Offshore Intangibles

President Obama's Deficit Reduction Plan would expand subpart F to include certain "excess income" from transactions involving the transfer of intangible rights from a U.S. taxpayer to a controlled foreign corporation (CFC), if the income is subject to a low foreign tax rate.

IMPACT. *The Treasury Department reported that income shifting through transfers of intangibles to low-tax affiliates has resulted in "a significant erosion of the U.S. tax base," and that treating excess income as Subpart F income would produce \$19 billion in revenue over 10 years.*

More International Provisions

Additional proposals, which together add another \$5 billion in revenue over 10 years, are being promoted as necessary to prevent inappropriate shifting of income outside the U.S. They include reforms to:

- Limit income shifting through intangible property transfers: The definition of intangible property for purposes of the special rules relating to transfers of intangibles by a U.S. person (Code Sec. 367(d)) would be clarified. The Administration estimates this proposal would reduce the deficit by \$1 billion over 10 years.
- Limit earnings stripping by expatriated entities: The rules that limit the deductibility of interest paid to related persons who would owe little or no U.S. taxes on the interest would be amended for inverted company transactions that in-

appropriately reduce U.S. taxes on income earned from U.S. operations. The Administration estimates this proposal would reduce the deficit by \$4 billion over 10 years.

JOINT SELECT COMMITTEE

President Obama's Deficit Reduction Plan is one of several proposals the Joint Select Committee on Deficit Reduction will consider in the coming weeks. The tax-writing committees of the House and Senate are also expected to have proposals for deficit reduction. The joint committee will also receive deficit reduction proposals from individual lawmakers, special interest groups, industry groups, and citizens.

IMPACT. *The joint committee is charged under the Budget Control Act of 2011 to present legislative language to Congress to reduce the federal budget deficit. If the joint committee fails in its task, or if Congress rejects the joint committee's plan, automatic across-the-board cuts will apply.*

COMMENT. *The 12-member joint committee is equally divided between Democrats and Republicans. Some Washington observers predict this division is a recipe for stalemate. Others predict that the lawmakers will compromise, especially in closing perceived tax loopholes.*

IMPACT. *Leaving no doubt about his opposition to extending the Bush-era tax cuts for higher income taxpayers, President Obama vowed to veto any legislation drafted by the Joint Select Committee on Deficit Reduction and passed by Congress that is not a balanced deficit reduction package of spending cuts and revenue raisers.*