Deficits & Politics To Drive 2011 Tax Policy

By Tom Neubig and Michael Dell

With deficit and budget concerns, legislators and policymakers in Washington are grappling with difficult decisions regarding deficit reduction and tax reform. Balancing the desire for some additional short-term fiscal stimulus and targeted tax reductions with long-term deficit reduction goals will make this year challenging for lawmakers.

Growing concern about the federal deficit will shape tax policy this year. However, the political reality of a divided government and the politically difficult decisions required for deficit reduction and tax reform may limit lawmakers' ability to come together around meaningful tax legislation.

With the arrival of 2011, the economic situation is sobering. Large deficits, a recovering but sluggish economy and unemployment remaining close to 10 percent provide a stark backdrop for potential legislative activity in 2011. Balancing the desire for some additional short-term fiscal stimulus and targeted tax reductions with long-term deficit reduction goals and pay-as-you-go (PAYGO) requirements will be a challenge for lawmakers.

At press time it was unclear whether the tax package would become law, but the proposal appeared to reflect a possible shift from the stalemate over tax legislation that had characterized much of last year. What is ultimately accomplished will depend on the personalities and politics involved and whether lawmakers opt for continued partisan dueling or legislative pragmatism.

The timing and size of future deficit reduction will be a major political issue this year. Political gridlock caused tax legislation to languish for much of 2010, creating tremendous uncertainty for taxpayers, employers and planners.

In early December, with just a few weeks left to the congressional session, President Barack Obama announced the framework of a deal with lawmakers that would extend tax cuts enacted under President George W. Bush for two years for all taxpayers, provide a seamless extension of certain expired tax provisions, "patch" the alternative minimum tax for two years and establish an estate tax regime for 2011 with a 35-percent maximum rate and $5-million exemption per individual.

The tentative deal included 100-percent expensing of capital investments for 2011, as well as a two-year extension of the research and development tax credit. It also included economic stimulus measures, notably a 13-month extension of unemployment benefits and a one-year payroll tax cut for employees in 2011.

The deal immediately drew criticism from some congressional Democrats, and at press time it was unclear whether the tax package would become law. But the proposal appeared to reflect a possible shift from the stalemate over tax legislation that had characterized much of last year.

The Political Landscape

What is ultimately accomplished will depend on the personalities and politics involved and whether lawmakers opt for continued partisan dueling or legislative pragmatism. In the midterm elections, the Republicans gained more than 60 seats and a majority in the House of Representatives, picking up six seats but remaining in the minority in the Senate.

As the initiator of tax legislation, the House is likely to focus on spending reductions, with a reluctance to raise revenues. The Republican House is likely to find the Senate, with its budget rules, a continuing roadblock for tax legislation.

The Senate's 60-vote requirement to avoid a filibuster may be even more difficult to obtain with only 53 Democratic votes. Potential compromises may be stalled by Senate Republicans insisting on no tax increases and further spending reductions and by Democrats displeased with particular spending reductions.

Although the Democrats no longer hold the majority in both houses of Congress, President Obama will still be the key player in federal policy in 2011. Republican attempts to scale back health care reform and financial regulatory reform would require overcoming a presidential veto with a 67-percent supermajority.

Large deficit-reduction cutbacks in spending without some tax increases also would face a veto hurdle. The president's proposed fiscal 2012 budget, which will be delivered in February, will indicate the extent to which the president will commit the next two years of his term to deficit reduction and/or tax reform.

Congress and the White House have one thing in common — the desire to address and reform corporate and individual taxes in a way that will grow the United States economy and please their constituents back home. So it is anticipated that taxes will continue to be at the forefront of the Washington agenda.

Regulatory and Administrative Focus

The years 2009 and 2010 included major legislation on stimulus, education, health care and financial regulatory reform. Tax legislation enacted through November 2010 included $448 billion of new tax increases over 10 years.

This year will likely see the issuance of regulations implementing the new laws and increased enforcement of existing laws, including tax enforcement measures. The Internal Revenue Service's Uncertain Tax Positions (UTP) initiative is an example of tax administrators' global interest in greater transparency and increased disclosure.

The IRS has restructured its Large and Mid-Sized Business division into a Large Business and International division, emphasizing its focus on cross-border transactions and other

international issues, such as transfer pricing, migration of intangibles and global high net worth individuals. This dovetails with several of the president's fiscal 2011 international tax budget proposals, which are likely to face even more opposition in the new Congress.

The increase in the number of tax treaties and tax information sharing agreements, combined with tax administrators around the world desiring to use them to share information, brings a global dimension to tax administration. Thus, the international tax gap and transparency will likely continue to have a significant emphasis.

In 2010, major tax information and withholding requirements were enacted, including expanded Form 1099 reporting on payments to corporations and the Foreign Account Tax Compliance Act requirements on foreign financial institutions. Basis reporting on securities transactions and reporting on payment card transactions will start in 2011. Legislative attempts to roll back or repeal the new information reporting requirements on payments to corporations are occurring, but face PAYGO hurdles.

More information reporting and withholding, combined with more enforcement, becomes an even stronger tool to raise revenue and address the tax gap.

Focus on Deficit Reduction: 'Reducing the Red Ink'

President Obama signaled the importance of deficit reduction as a policy goal with last year's creation of a deficit reduction commission, officially called the bipartisan National Commission on Fiscal Responsibility and Reform.

The commission — made up of three Republican and three Democratic senators, three Republican and three Democratic representatives and six presidential appointees — was charged with making recommendations to reduce the U.S. budget deficit (excluding interest on the federal debt) to 3 percent of GDP by 2015 from roughly 9 percent of GDP today, and stabilizing the debt-to-GDP ratio.

The commission adjourned in early December after completing a final report framed by a stark assessment of the United States' current fiscal situation. The plan included sweeping proposals to lower tax rates, eliminate most tax expenditures, cut spending and establish a territorial tax system, all with the goal of reducing the deficit by $4 trillion over the next decade.

Specifically, the plan would lower the corporate tax rate to between 23 percent and 29 percent, while eliminating corporate tax expenditures, and lower individual income tax rates by eliminating all but the most popular individual tax expenditures, which would be reduced. It would also limit the growth of health care spending and increase the Social Security retirement age.

Significantly, 11 of the commission's 18 members signed off on the plan, but support fell short of the 14 votes needed to send the plan to Congress for a vote. The commission's plan and the response to it demonstrated the challenge lawmakers will face as they continue to examine ways to reduce the deficit.

Elements of the plan may well resurface as the deficit reduction policy debate continues in the months ahead. While the U.S. and Japan were still considering additional fiscal and monetary stimulus at the end of 2010, most other highly developed countries had turned to fiscal austerity measures (deficit reduction) in the wake of the sovereign debt crisis in Europe. Many countries are cutting spending, raising retirement ages and increasing taxes to move toward sustainable debt and deficit levels.

For example, the United Kingdom government proposed significant spending reductions, increasing its value-added tax rate to 20 percent, increasing capital gains tax rates on high-income earners and increasing tax enforcement resources.

As a sign that some tax reductions and tax reform are possible even in the midst of deficit reduction, the U.K. government proposed cutting its corporate tax rate from 28 percent to 24 percent by 2015.

Deficit reduction will also be an important issue for many state and local governments. The lingering effects of the recession and the effects of declining real estate values on property tax collections will force state governments to continue to tighten their budgets and potentially increase taxes.

Congress and the White House have one thing in common — the desire to address and reform corporate and individual taxes in a way that will grow the United States economy and please their constituents back home. So it is anticipated that taxes will continue to be at the forefront of the Washington agenda.

Corporate income taxes account for less than 10 percent of total state and local business taxes, so paying close attention to non-income tax changes will be important.

Tax Reform

The deficit commission's plan includes a combination of deficit reduction and tax reform. The proposal would broaden the income tax base while lowering tax rates and dedicating almost $1 trillion of tax increases over 10 years for deficit reduction. The Tax Reform Act of 1986, which was revenue neutral, was

preceded by three significant deficit reduction acts in 1982, 1983 and 1984, where Congress legislated despite political opposition from interest groups. The last significant deficit reduction legislation was in 1993.

The deficit commission's plan drew upon several previous tax reform proposals, among them a plan introduced in February by Senate Finance Committee member Ron Wyden (D-Ore.) and Sen. Judd Gregg (R-N.H.), the ranking Republican on the Senate Budget Committee. The Wyden-Gregg proposal would establish three individual tax rates, repeal the AMT, triple the standard deduction, place limits on the mortgage deduction and cap the income tax exclusion for employer-provided health care.

The deficit commission's plan would establish a corporate tax rate between 23 and 29 percent, eliminate all business tax expenditures and replace the current international tax system with a territorial tax system.

Territorial tax systems in most other countries exempt dividends of active foreign-source income paid by overseas subsidiaries, but important details such as the treatment of expenses attributable to foreign source income could affect whether a territorial system would result in a tax increase or tax reduction for U.S. multinational companies.

Tax policy observers have repeatedly called for closer examination of tax expenditures. A recent House bill to extend expiring tax provisions, for example, included a requirement that the Joint Committee on Taxation evaluate the effectiveness of each expiring provision. Limiting tax expenditures may be a compromise for some Republicans, who can argue they are cutting spending at the same time that overall tax revenues increase.

These and other tax reform ideas may be considered in the new Congress as lawmakers look for ways to cut deficits once the economy has stabilized. The Senate Finance Committee held initial hearings on tax reform in September and December 2010, and it is likely that the congressional tax-writing committees will continue hearings on tax reform this year.

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Other Legislative Drivers

The president's 2012 proposed budget — to be submitted to Congress in February — may renew the call for additional short-term stimulus plus longer-term deficit reduction. Before the 2010 election, the president proposed a temporary 100-percent bonus depreciation, permanent extension of the research credit and $50 billion in infrastructure spending.

He may propose a combination of short-term stimulus with longer-term deficit reduction, drawing upon some of the ideas of the deficit commission. He may also revive a host of revenue-raising tax offsets included in last year's budget proposal.

The federal debt limit will require Congress and the president to examine budget priorities and will likely be an action-forcing event for spending reductions.

U.S. debt is expected to reach the $14.3 trillion limit sometime in the spring of 2011. Republican congressional leaders have said they want to tie raising the debt ceiling to spending reductions. The U.S. has never defaulted on its debt, but past debt limit debates have resulted in major showdowns and Treasury debt maneuvers before eventual compromise.

Legislation extending temporary expiring provisions had been an engine for annual tax legislation for many years until 2009 and 2010. Extenders were passed three times by the House in 2010 but could not make it through the Senate due to concerns about the revenue offsets. The tentative deal as of press time would extend expiring provisions through 2011, a further extension is likely to be debated again near the end of the year.

Other policy initiatives that involve tax elements, such as energy policy, will likely be considered this year, and will have to overcome similar hurdles.

While the first part of 2011 may well be spent attempting to resolve some tax issues left over from last year and considering fiscal stimulus, there will be mounting pressure on members of Congress and the president to work toward finding longer-term solutions to the deficit problem. Spending reductions, greater scrutiny of tax expenditures and increased tax enforcement and compliance measures will be debated.

From a business perspective, the possibilities are varied enough — and the politics charged enough — that paying close attention to legislative, regulatory and administrative developments will be important in preparing for the potential changes ahead.

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