

BLOG POST

Post-Election Update: Lame Duck Session, Taxes and the Fiscal Cliff

November 21, 2012

When Congress reconvenes on November 13, the legislature will be faced with issues they have been postponing the entire year: the so-called Fiscal Cliff. With basically a status quo election, there is a good chance that the Fiscal Cliff issues will be dealt with prior to the conclusion of the 112th Congress.

What are the issues that make up the Fiscal Cliff?

The scheduled cuts and estimated savings from those cuts by category in FY 2013 include:

- Sequestration: \$109 billion (half from defense and half from other spending)
- Tax Cuts, 2001/2003 Bush Tax Cuts: \$110 billion (if tax cuts are not extended, top dividend rate could increase to 39.6%, capital gains tax rate would increase from 15% to 20%)
- Tax "Extenders": \$30 billion (traditional extenders that expired at the end of 2011 and 2012)
- Expiration of Payroll Tax Holiday: \$85 billion (least likely to be extended although Democrats raised it as an issue in the closing days of the election)
- Expiration of Unemployment Benefits: \$34 billion
- Cuts in Medicare Payments (Doc Fix): \$10 billion
- Individual Alternative Minimum Tax (AMT): \$104 billion (expired end of 2011)

There are several factors that will encourage Congress to address these issues. First, sequestration will have the Appropriators and the Armed Services Committees work to avoid these cuts. They will look to the tax writing committees to prevent the cuts from going into effect by finding ways to pay-for the cuts. Second, the budget hawks will want to reduce the deficit, which will lead to some type of "down payment" that will include hard cuts and revenue raisers. The amounts of revenues and cuts will need to exceed the amount called for in the first year of sequestration. In addition, Congress will be reluctant to sign onto entitlement cuts and revenue raisers unless there is a path forward on tax reform and entitlement reform. Third, the hard decisions will come from deciding what type of enforcement (trigger or backstop) mechanism to enforce the down payment agreement.

Finally, Congress will have to deal with another debt ceiling vote. While the debt ceiling will be reached in December (current debt ceiling is \$16.39 trillion), there are ways that Treasury can postpone the day of reckoning until sometime in February or March 2013. There will likely be a demand to match deficit reduction amounts to the amount the debt ceiling is raised, similar to what Speaker Boehner did in 2011.

If Congress kicks some of these decisions down the road, they will probably do so by extending the dates until the end of 2013. The one item that cannot be extended is the AMT which expired at the end of 2011. Taxpayers will want to file their tax returns in February 2013 to get their tax refunds and if Congress has not acted on the AMT, many additional taxpayers will find that they are not getting a refund and will be paying additional taxes.

Tax Reform

With the status quo election behind us, Congress will turn to tax reform in 2013. President Obama will want to raise the tax rate on upper income individuals. Here is a summary of his tax proposal:

Corporate:

- Reduce the corporate rate from 35% to 28% (25% for manufacturing)
- Opposes a territorial system and set a minimum tax on overseas earnings

Individual:

- Allow Bush tax cuts to expire for families earning above \$250,000 a year and raise rate on top bracket to 39.6%
- Limit amount of deductions high income workers can take and set a minimum tax rate for millionaires ("Buffet Rule," a 30% surtax on income over \$1 million)

Tax reform is the number one priority for House Ways & Means Committee Chairman Dave Camp. In the 112th Congress, there were over 20 hearings in the Committee on tax reform. While the Committee released legislative language on an international territorial system, neither the Senate Finance Committee or House Ways & Means has released concepts or legislative language on what they will propose on corporate or individual taxes.

With the growth of pass-through entities, tax reform will include both individual and corporate taxes. Also it is unlikely that Congress will use reconciliation as the vehicle for tax reform. As we have seen with the Bush 2001 and 2003 tax cuts, reconciliation permits a tax cut to be in existence for only ten-years. Congress cannot pass comprehensive tax reform and have it snap back to existing law ten-years down the road.

One of the problems that Congress will have to deal with is the effective tax rates that some sectors of the economy are paying under current law. Those that have less than 28 percent effective tax rates will not be happy to give up their tax preferences and deductions so that other sectors of the economy can have their tax rates reduced to 28 percent. See below table.

Effective Tax Rates of the 20 Largest Industrial Sectors

- Biotechnology: 4.46%
- Drug: 5.62%
- Internet: 5.94%
- Metals & Mining: 7.41%
- Computer / Peripherals: 8.65%
- Computer Software/Services: 10.12%
- Semiconductor: 10.85%
- Medical Supplies: 11.24%
- Petroleum (Producing): 11.27%
- Auto Parts: 12.09%
- Telecom Services: 12.80%
- Hotel/Gaming: 12.93%
- Food Processing: 17.29%
- Bank: 17.50%
- Restaurant: 19.86%
- Aerospace/Defense: 20.05%
- Oilfield Services/Equipment: 22.05%
- Trucking: 30.87%
- Petroleum (Integrated): 33.00%
- Electric Utility (East): 33.77%

Another problem Congress will have in reducing the individual rate is having individuals give up popular tax deductions. See below chart.

Largest Individual Tax Expenditures

- Exclusion of health care contributions and premiums: \$659.4 billion
- Deduction of mortgage interest: \$484.1 billion

- Reduced tax rates on dividends and long-term capital gains: \$402.9 billion
- Net exclusion of pension contributions and earnings: Defined benefit plans: \$303.2 billion
- Earned Income Credit: \$268.8 billion
- Deduction of non-business state and local government taxes: \$273.3 billion
- Net exclusion of pension contributions and earnings: Defined contribution plans: \$212.2 billion
- Exclusion of capital gains at death: \$194.0 billion
- Deductions for charitable contributions, other than education and health: \$182.4 billion
- Exclusion of untaxed social security and railroad retirement benefits: 173.0 billion

We anticipate the tax writing committees to begin work on tax reform at the beginning of the 113th Congress. Prior to marking up any legislation, we think that the Committees will release either legislative language or concepts. The feedback that the Committees receive on their proposals will impact the speed and ability of the Committees to accomplish their goals.