2013 Fall legislative outlook: focus on tax reform

September 5, 2013

In brief

Efforts to advance tax reform legislation move into a critical phase this fall. Meanwhile, President Obama and Congress will be addressing the issue of military action against Syria and confronting fiscal policy deadlines to avoid a partial government shutdown and default on the federal debt.

The House and Senate tax committees in coming months hope to move beyond hearings and discussions of tax reform and initiate formal action on comprehensive tax reform legislation. House Ways and Means Chairman Dave Camp (R-MI) has indicated his committee will begin to act in October on a comprehensive bill. Senate Finance Chairman Max Baucus (D-MT) has said that he hopes the Finance Committee can move on a tax reform bill before Thanksgiving. As part of their ongoing efforts to build support for action, Chairmen Camp and Baucus will appear in Memphis on September 9 for the fourth in a series of tax reform 'road show' events.

Congress returns September 9 from a five-week recess to begin debate on a resolution authorizing military action against Syria, with House and Senate votes possible by mid-September. On the domestic front, Congress needs to agree on funding the federal government for fiscal year 2014, which begins October 1, to avoid a shutdown of federal agencies. In addition, Congress will need to increase the federal debt limit, following the recent announcement by Treasury Secretary Jack Lew that the federal government will exhaust its ability to meet scheduled federal spending obligations under the current $16.7 trillion debt limit by mid-October. Congress this fall also has many other issues to consider, including expiring business and individual tax provisions, bills on remote sales tax collection, tax treaties awaiting Senate approval, energy legislation, oversight of the IRS, and politically challenging debates over immigration reform and reauthorization of federal farm and food assistance programs.

As Congress focuses on fiscal policy deadlines, the debate over whether tax reform should be revenue neutral or should raise revenue for deficit reduction likely will intensify. While Ways and Means Chairman Camp supports revenue-neutral tax reform, Finance Committee Chairman Baucus generally has said that tax reform should generate some new revenue for deficit reduction. Budget negotiations associated with the debt limit and government funding could provide a path forward on tax reform.

In detail

House Ways and Means Committee action planned

During a joint event in August with Chairman Baucus to promote reform, Chairman Camp said that he and his staff are working to 'fill in the blanks' on business and individual tax reform legislation that will build on previously released discussion drafts on international, partnership, and financial instrument tax rules.

It remains to be seen what specific changes Chairman Camp may propose to earlier discussion drafts in response to public hearings and input from stakeholders when he unveils his official 'chairman's mark' in coming weeks.

Chairman Camp is expected to meet with Ways and Means Republicans over the next few weeks to get their input in advance of the House tax committee beginning the formal process of considering tax reform legislation and voting on amendments. While he has been discussing tax reform with Ways and Means Democrats, Chairman Camp likely will have to rely almost exclusively on his Republican colleagues for the votes to pass a comprehensive tax reform bill out of committee.

Note: Ways and Means action on a comprehensive tax reform bill could take some weeks. In 1985, when the Ways and Means Committee previously acted on a comprehensive tax reform bill, the committee held 26 days of markup sessions to produce the first version of the bill that eventually became the Tax Reform Act of 1986.

A key issue to be addressed will be agreeing on base-broadening provisions to offset the cost of lower corporate and individual tax rates. Chairman Camp has said that he supports the goal of moving to 10% and 25% individual tax rate brackets – in place of the seven current tax brackets with a 39.6% top individual tax rate – and providing a more globally competitive business tax system, with a top corporate tax rate of 25%.

Highlighting the difficulty of base broadening, some Republican members during the August recess discussed with constituents that the base-broadening proposals could be painful for those affected, but that everyone needed to evaluate the tax reform package as a whole.

According to Joint Committee on Taxation (JCT) revenue estimates released in late July by Ways and Means Democrats, reducing current individual tax rates to 10% and 25% would reduce federal revenues by $3.45 trillion over 10 years. Repealing the individual alternative minimum tax (AMT) would increase the cost of those lower rates by an additional $317.2 billion over the same period. Ways and Means Democrats also released a JCT staff estimate projecting that reducing the top corporate tax rate to 25% would reduce revenues by $1.23 trillion over 10 years; the additional cost of repealing the corporate AMT would increase that overall revenue loss to $1.3 trillion over 10 years.

Observation: While offsetting the cost of a significant corporate rate reduction will require many critical decisions affecting the business community, lowering the top individual tax rate to 25% will pose an even greater challenge since revenue offsets would involve modifying or limiting widely used individual tax exclusions, preferences, and deductions.

Note: As a reference point, the 2013 JCT tax expenditure report (JCS-1-13) indicates that the largest business 'tax expenditures' include deferral of CFC active income; the section 199 domestic production manufacturing deduction; the exclusion of interest on public purpose tax-exempt bonds; the tax credit for low-income housing; expensing of research and experimental expenditures; the last-in, first-out (LIFO) inventory method; and the research credit. (The current five-year tax expenditure estimate for accelerated depreciation has been reduced by recent law providing 'bonus' depreciation deductions since 2008.) The same report identifies the top five individual tax expenditures as the exclusion for employer-provided and self-employed health care; the exclusion of retirement contributions and earnings; the reduced rate on capital gains and dividends; the deduction for state and local income, sales, and property taxes; and the mortgage interest deduction.

For detailed insights on prior tax reform discussion drafts released by Chairman Camp, see WNTS Insights:

- Ways and Means Chairman Camp releases discussion draft for corporate rate reduction, territorial tax system (November 1, 2011)
- Ways and Means Discussion Draft proposes major changes to taxation of financial products (February 12, 2013)
- Ways and Means Committee releases pass-through tax reform discussion draft (March 12, 2013)

Senate Finance Committee deliberations continue

In August, Finance Chairman Baucus said that he and Finance Ranking Member Orrin Hatch (R-UT), along with Finance Committee staff, continue to weigh tax reform proposals from Senators who responded in late July to their call for comments on a 'blank slate' approach to tax reform. That approach assumes the elimination of all business and individual tax expenditures in exchange for lower tax rates. Chairman Baucus and Senator Hatch cautioned that adding back all or part of certain tax expenditures would affect how much rates could be cut.

As part of a process launched by Chairman Baucus and Ranking Member Hatch to begin developing tax reform legislation, Finance Committee members earlier this year met weekly to discuss a series of options papers on a wide range of issues within tax reform. Chairman Baucus has indicated that he will continue to meet individually with members of the Finance Committee and other Senators to discuss their tax reform priorities in preparation for legislative action.

Observation: The prospects for action by the full Senate on tax reform legislation remain uncertain given sharp disagreement in that chamber over raising revenue as part of tax reform. Senate Majority Leader Harry Reid (D-NV) has said that tax reform must raise significant revenue. Senate Minority Leader Mitch McConnell (R-KY) has said that any call for new revenue is a 'stumbling block for even getting started' on tax reform legislation.

Obama Administration focus on 'business tax reform'

President Obama generally has focused on business tax reform rather than comprehensive tax reform. The Administration has expressed some willingness to consider individual tax reform in exchange for increased revenue being provided for deficit reduction.

On July 30, 2013, President Obama called for 'pro-growth tax reform and jobs package' that would use 'one-time revenues' raised from closing 'loopholes' during a transition to a new business tax reform system to fully offset the cost of increased spending on infrastructure and job training programs. His July 30 tax reform remarks were seen as a departure from previous Administration statements that 'business tax reform' should be purely revenue-neutral.

Note: At the time, White House officials in public comments cited changes to accelerated depreciation and rules governing the repatriation of foreign income as examples of transitional revenue that may result from any tax reform legislation, but the Administration did not detail specific 'one-time revenues' in the President's proposal.

The Obama Administration FY 2014 budget proposal reserves more than $300 billion in international and domestic tax increase proposals for 'revenue-neutral business tax reform.' The President also called for $580 billion in new tax increases for upper-income individuals, with additional business and individual revenue raisers proposed as offsets for Administration spending initiatives.

The budget does not propose a specific tax reform plan, but calls on Congress to work with the Administration on 'corporate tax reform that will close loopholes, lower the corporate tax rate, encourage investment at home, and not add a dime to the deficit.' For more on the President's budget and tax proposals, see the April 10, 2013 WNTS Insight – Obama Administration FY 2014 budget focuses on tax reform, deficit reduction, and new initiatives.

In early 2012, President Obama released a 25-page 'framework for business tax reform,' in which he calls for a revenue-neutral 28% top corporate tax rate and a tax rate of no more than 25% for certain domestic manufacturers. The framework also calls for a permanent research credit and a minimum tax on foreign earnings.

Business tax extenders

While the current focus of the House and Senate tax committees is on tax reform, several business and individual tax provisions are set to expire at the end of the year. Key expiring business tax provisions include the research credit, 'look-through' treatment of payments between CFCs, and the subpart F active financing exception.

It is likely that tax reform legislation could result in permanent extension of some but not all of the current temporary provisions. However, since consideration of a comprehensive tax reform bill is likely to continue into 2014, Congress will need to consider next year a retroactive renewal of certain expiring tax provisions.

Observation: We believe it is unlikely that Congress will consider tax extenders legislation in 2013 while tax reform remains under consideration. The research credit and many other temporary tax provisions were last renewed on a retroactive basis as part of the 2012 'fiscal cliff' legislation that included a permanent extension of 2001 and 2003 tax rates for most individuals and higher rates for upper-income taxpayers.

Fiscal policy deadlines

Avoiding a government shutdown

None of the 12 annual appropriations bills for fiscal year 2014 has been enacted. The House and Senate each approved budget resolutions in March; these budget plans differ by $91 billion, or nearly 10%, on the level of annual discretionary spending for federal departments and agencies.

This disagreement over spending increases the risk of a partial shutdown of the federal government after September 30, when current funding for federal departments and agencies expires. Many expect the House and Senate will reach agreement on a temporary continuing resolution (CR) before September 30, although some Republicans insist that they will not vote for a CR unless funding is denied for implementation of the Affordable Care Act (also known as Obamacare).

The House and Senate have not made noticeable progress since March in resolving their broader disagreement over how to reduce future federal budget deficits. The House-approved FY 2014 budget resolution would balance the federal budget in 10 years by cutting $4.6 trillion in future spending and ruling out any new tax increases. The Senate budget resolution calls for a $975 billion tax increase over 10 years as part of a 'balanced' package of revenue increases and spending cuts that together would reduce projected federal deficits by $1.85 trillion by FY 2023.

Debt limit increase

Treasury Secretary Lew on August 26 officially informed Congressional leaders that the Treasury Department by mid-October will exhaust the 'extraordinary measures' that have been used to finance the federal government since May 17, when the current $16.7 trillion debt limit was reached. In his letter to House and Senate leaders, Secretary Lew said that 'Congress should act as soon as possible to meet its responsibility to the nation and remove the threat of default.'

Note: The debt limit debate is coming sooner than many had anticipated. The Congressional Budget Office's most recent projection was that Treasury might exhaust its ability to operate under the current debt limit as late as November.

House Speaker John Boehner (R-OH) has said that House Republicans will insist on 'cuts and reforms that are greater than the increase in the debt limit.' Treasury Secretary Lew has reaffirmed President Obama's refusal to negotiate over a debt limit increase, as well as any move to de-fund or delay implementation of Obamacare.

Debt limit increase negotiations in 2011 led to a failed 'super committee' deficit reduction effort and an ongoing series of annual across-the-board 'sequestration' spending cuts totaling $1.2 trillion through 2023. President Obama and Congressional Democrats have made it a priority to replace sequestration spending cuts with a mix of alternative spending cuts and increased tax revenue.

White House officials recently have been meeting with a group of Republican Senators to discuss a potential bipartisan compromise on deficit reduction that would replace some of the scheduled sequestration spending cuts. Those talks are reported to have hit an impasse because of differences over tax increases that Administration officials said would have to be part of any agreement.

In the past, some Republican Congressional leaders have suggested that an increase in the debt limit could be tied to deadlines for future action on tax reform legislation in both the House and Senate. Other Republican priorities include blocking implementation of Obamacare, additional discretionary spending cuts, and changes to mandatory spending programs, including Medicare, Medicaid, and Social Security.

Observation: Action on a CR and debt limit increase could be combined into a short-term bill providing a temporary period for continued negotiations on a 'grand bargain' between the White House and Congress. It remains to be seen whether a 'path forward' on tax reform will be part of such legislation.

The takeaway

The challenge of advancing comprehensive tax reform will involve addressing many complicated and potentially contentious decisions on trade-offs between modifying or limiting business and individual tax expenditures and lowering tax rates and enacting a more modern, globally competitive tax code. This challenge exists even if tax reform is considered on a strictly revenue-neutral basis, and increases if part of the revenue from individual and corporate base broadening is to be used for deficit reduction or one-time infrastructure spending, as President Obama and many Congressional Democrats have proposed.

It is critical for the business community to stay engaged in the tax reform process, as decisions being made by the House Ways and Means Committee and the Senate Finance Committee will form the basis for tax reform whether a final reform bill is enacted by this Congress or a future Congress.

In addition, the business community should be involved in the short-term and long-term debates on the federal budget and deficit reduction, as decisions on these issues could directly impact tax reform efforts and potential corporate tax increases. Devoting revenue from corporate 'base-broadening' measures to deficit reduction or new spending instead of tax reform would make it harder to reduce tax rates to a rate comparable to our trading partners and to enact a competitive international tax system. Attempting to raise additional revenue from individuals would complicate the ability of Congress to act on comprehensive business and individual tax reform due to differences between the two parties.

Divided government—as well as disagreement between Republicans and Democrats in Washington over a so-called balance between tax increases and spending cuts as part of the budget and debt ceiling discussions – will be a challenge to tax reform. However, the recognition by both parties that our current tax code is an impediment to stronger economic growth may be the driver for both sides to work together on comprehensive tax reform that lowers tax rates and provides a competitive international tax system.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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