WNTS Insight

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2012 election results point to continued divisions over tax policy

In brief

The November 6 election results indicate that President Barack Obama has been elected to a second term. At this writing, President Obama has been projected to have won 303 electoral college votes against 206 for former Massachusetts Governor Mitt Romney (Florida has not yet been called). Although some Congressional races remain undecided, both House Republicans and Senate Democrats are on track to retain majorities in the next Congress.

While the 113th Congress will not take office until January 3, 2013, the current Congress is scheduled to return next week for a lame duck session in which House and Senate members now serving are expected to address expired and expiring business and individual tax provisions, including individual tax rates, as well as scheduled cuts in U.S. defense spending and other federal programs. In addition, it is likely that there will be an effort to pass a relief package for those areas impacted by Superstorm Sandy.

The continued division of power in Washington raises the question whether compromises can be reached before the end of this year to avoid the "fiscal cliff" effect of scheduled tax increases and spending reductions. The Federal Reserve and the Congressional Budget Office have warned that the United States risks a recession in early 2013 if no action is taken during the upcoming lame duck session.

Actions to think about

Individual and business taxpayers will want to pay close attention to legislative developments over the next several weeks that could have a significant impact on year-end tax planning. The Insight below examines key tax policy issues that need to be addressed before December 31, 2012, and also discusses the outlook for tax reform in light of the 2012 elections.

Outlook for year-end action

With the elections behind them, there is hope that President Obama and Congressional leaders can bridge differences over whether to extend some or all of the 2001 and 2003 individual tax rates set to expire on December 31. At the same time, there remains a concern that the closeness of the election results will not have provided a clear signal for policymakers.

White House officials prior to the elections issued a veto threat against any lame duck legislation that continues current tax rates for higher-income individuals. Some Senate Republicans have indicated that there may need to be some concession on tax rates for higher-income individuals, but House Speaker John Boehner (R-OH) last night stated that "there is no mandate for raising tax rates." Speaker Boehner before the elections suggested that the lame duck session instead should provide additional time for the next Congress to address key issues by delaying year-end deadlines into 2013 (effectively extending all current tax rates for a period of time).

The outlook for the lame duck session is complicated by a recent Treasury Department announcement that the current $16.394 trillion federal debt limit will be reached by the end of the year, but that "extraordinary measures" can be taken by Treasury to manage the government's debt through early 2013. Treasury officials previously had indicated that the debt limit might not be reached until next year.

President Obama during the campaign was reported to have discussed the prospects for a "grand bargain" on revenue increases and spending reduction "within six months of the elections." White House officials have indicated that the Administration remains committed to proposals put forth last year. For more information on the Administration previous deficit reduction proposal, see the September 19, 2011 "WNTS Insight - President Obama proposes $1.5 trillion in new taxes as part of deficit reduction plan; calls for comprehensive tax reform." Expectations are tempered by the fact that the Administration and Congressional leaders had been unable to reach a deficit reduction agreement in 2011 under the process set forth under the most recent increase in the federal debt limit.

Decisions on how best to reform US tax laws in a way that promotes economic growth and the global competitiveness of the United States are expected to be left to the next Congress. President Obama and Congressional leaders generally agree that the U.S. corporate tax rate is too high and that the cost of corporate reforms should be offset by broadening the corporate tax base. However, significant differences exist over how best to reform international tax rules and the role of increased revenues as part of efforts to reduce future federal budget deficits. It also remains uncertain whether any lame duck session agreement on fiscal cliff issues might set forth a tax reform framework or process for the next Congress.

Lame duck agenda

While the current Congress returns to Washington on November 13, negotiations between the White House and Congressional leaders are expected to take some weeks to complete, assuming an agreement can be reached. In 2010, an agreement addressing individual tax rates and other issues as part of the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act" was not announced until December 6, and the legislation was not signed into law until December 17.

Expiration of individual income tax rates

Efforts to resolve differences over the scheduled expiration of current individual tax rates at the end of this year are expected to be the most difficult point of contention during the lame duck session.

The House and Senate during the summer approved differing individual tax rate bills generally along party-lines. The Democratic-led Senate on July 25 voted 51 to 48 to approve the "Middle Class Tax Cut Act of 2012" (S. 3412), which generally would extend for one year current individual tax rates for individuals with adjusted gross income (AGI) below $200,000 ($250,000 for joint filers). S. 3412 also would reinstate the phase-out of itemized deductions and personal exemptions for individuals with incomes above the AGI thresholds. The Republican-controlled House on August 1 voted 256 to 171 to approve the "Job Protection and Recession Prevention Act of 2012" (H.R. 8), which would extend for one year 2001 and 2003 tax provisions for individuals at all income levels.

Tax rates for investment income are an area of additional concern for individuals considering year-end tax planning. The Senate-approved bill generally extending current tax rates for taxpayers with AGI below $250,000 would provide for a top rate of 20 percent for most capital gain and qualified dividend income, while the House-approved bill would retain a top rate of 15 percent for such income. If no action is taken, beginning next year, the top general rate on long-term capital gains would be 20 percent while dividends would be treated as ordinary income, as also proposed by President Obama in his FY 2013 budget.

Health care law taxes

President Obama and Senate Democrats currently are not expected to accept any proposals during the lame duck session to delay implementation of the 2010 health care law. As reflected in the chart below, a new 3.8-percent additional Medicare health insurance (HI) surtax on certain net investment income and a related 0.9-percent increase in the HI tax on wages are scheduled to take effect next year under the 2010 health care law. The increased HI tax on wages and the new HI surtax will apply to single filers with AGI above $200,000 ($250,000 for joint filers).

Observations: The scheduled January 1, 2013 effective date of the new 3.8-percent net investment tax is expected to be a factor in decisions on whether to sell certain assets and realize gains before the end of this year. Some companies may consider paying special year-end dividends, and may re-evaluate stock buyback programs if rates for dividends and capital gains change.

Meanwhile, individuals and employers can anticipate that key provisions of the health care law will be implemented as scheduled. The Republican-controlled House since 2011 has voted more than 30 times to repeal all or parts of the health care law, but the Democratic-led Senate has blocked such efforts. It remains possible that the next Congress may consider proposals to modify how the health care law is implemented.

The chart below illustrates the top 2013 individual rates under H.R. 8 as approved by the House on August 1, assuming also that scheduled health care tax increases go into effect next year:

House Bill	Wage Income	Interest Income	Dividends	Capital Gains
2012 top rate	36.45%*	35.0%	15.0%	15.0%
2013 HI surtax	+0.9%	+3.8%	+3.8%	+3.8%
2013 top rate	37.35%	38.8%	18.8%	18.8%

The chart below illustrates the top 2013 individual tax rates under S. 3412 as approved by the Senate on July 25:

Senate Bill	Wage Income	Interest Income	Dividends	Capital Gains
2012 top rate	36.45%*	35.0%	15.0%	15.0%
2001/2003 tax cut expiration	+4.6%	+4.6%	+5.0%	+5.0%
2013 phase-out of itemized deductions	+1.2%	+1.2%	+1.2%	+1.2%
2013 HI surtax	+0.9%	+3.8%	+3.8%	+3.8%
Total increase in top rate	+6.7%	+9.6%	+10.0%	+10.0%
2013 top rate	43.15%	44.6%	25.0%	25.0%

* Includes 1.45% current-law employee share of Medicare HI tax (additional 1.45% applies for self-employed)

Estate and gift taxes

Estate and gift tax rates are another point of concern for some individuals, especially those considering transfers since the current $5 million gift exemption level is set to expire at the end of the year. The House-approved bill (H.R. 8) would extend current estate tax provisions through 2013, with a top rate of 35 percent and a $5 million exemption. The Obama Administration's FY 2013 budget proposes that the estate tax should be imposed at 2009 levels, with a top rate of 45 percent and a $3.5 million exemption; the Senate-approved individual tax rate bill did not include any estate tax provision. Absent further action by Congress, the estate tax under current law is scheduled to revert in 2013 to pre-2001 levels, with a top rate of 55 percent and a $1 million exemption amount.

Individual alternative minimum tax

More than 27 million additional households are projected to be subject to the alternative minimum tax for the 2012 return filing season next year if no agreement is reached to provide a temporary "patch" in AMT exemption amounts. IRS officials have cautioned that the processing of 2012 tax returns next year could be delayed by a late lame duck session action to increase AMT exemption amounts.

The House approved an AMT exemption increase for both 2012 and 2013 as part of its individual tax rate extension bill, while the Senate-approved individual tax rate bill would provide an AMT exemption increase only for 2012. In a separate bill addressing business and individual "tax extenders" (discussed below), the Finance Committee package approved an AMT exemption increase for 2012 and 2013.

Under the current proposals, the 2012 AMT exemption amount would be set at $50,600 for single filers ($78,750 for joint filers). The 2013 AMT exemption amount would be $51,150 for single filers ($79,850 for joint filers). Assuming current rates are extended for individuals at all income levels, the proposed AMT "patch" for 2012 and 2013 is estimated by the Joint Committee on Taxation staff to reduce revenues by $192.7 billion over ten years.

Business and energy tax extenders

Action this year to renew expired and expiring business and individual tax provisions may depend on whether President Obama and Congress can agree by year-end on legislation addressing expiring individual tax rates. If no compromise can be reached in the lame duck session on individual tax rates, legislation on other expired and expiring tax provisions also may be delayed until 2013.

The Senate Finance Committee on August 2 voted 19 to 5 to approve the "Family and Business Tax Cut Certainty Act of 2012," which would extend certain expired and expiring business and individual tax provisions through the end of 2013. That package includes a two-year extension of many tax provisions that expired at the end of 2011 – including the research credit, CFC look-through, active financing, and leasehold improvement depreciation – and a one-year extension of a modified renewable electricity production tax credit and certain other tax provisions scheduled to expire at the end of 2012. The Finance Committee bill is pending further consideration by the full Senate. For more information on the Finance Committee tax extenders bill, see the August 2 "WNTS Insight - Senate Finance Committee approves tax extenders bill renewing certain expired and expiring business and individual tax provisions."

The House Ways and Means Committee has been conducting its own review of tax extenders. Ways and Means Chairman Camp has stated that the House will address tax extenders before the end of the year. While there is bipartisan support in the House and Senate for extending most of the expired and expiring business and energy tax provisions, it remains possible that any final agreement on tax extenders may drop some provisions.

Estimated cost to extend select provisions through 12/31/2013	10-year amount ($ billions)
General business provisions	
Research credit	-$14.3
Active financing	-$11.2
CFC look-through	-$1.5
15-year recovery for qualified leasehold, restaurant, and retail property	-$3.7
Work opportunity tax credit	-$1.9
Other business tax provisions	-$8.6
Energy provisions	

Renewable electricity production credit	-$12.2
Biodiesel and renewable diesel credits	-$2.2
Other energy provisions	-$3.8
Total business and energy tax extenders	**-$59.4**

Source: Joint Committee on Taxation estimate of Senate Finance Committee tax extenders package, August 29, 2012

Payroll tax reduction

The current temporary percent reduction in the 6.2-percent Social Security employee payroll tax to 4.2 percent is scheduled to expire at the end of 2012. The Obama Administration and Congress initially agreed to reduce payroll taxes through 2011 as part of the 2010 agreement on expiring tax rates. Earlier this year, the payroll tax reduction was extended through December 31, 2012.

Treasury Secretary Timothy Geithner earlier this summer indicated that the Administration would not seek to extend the payroll tax reduction beyond December 31. More recently, White House officials have stated that a further extension of payroll tax reduction might be considered. Some Congressional Democrats, including House Budget Committee Ranking Member Chris Van Hollen (D-MD), have suggested that it was premature to rule out extending the current payroll tax reduction. House Ways and Means Chairman Dave Camp (R-MI) recently stated that House Republicans do not support extending the payroll tax reduction beyond the end of 2012.

Automatic spending cuts and other fiscal cliff issues

The Federal Reserve and CBO have cited scheduled spending reductions as part of the fiscal cliff challenge facing the Administration and Congress in the lame duck session. It remains uncertain how President Obama and Congressional leaders can bridge differences over revenues and spending to stop scheduled spending cuts from going into effect, but this issue is expected to play a key role in an overall agreement on any year-end legislation.

As a consequence of the failure to agree last year on a deficit reduction compromise, the Budget Control Act of 2011 provides $1.2 trillion in automatic spending cuts over nine years beginning January 3, 2013. These cuts would be implemented under a "sequestration" order to be issued by the White House Office of Management and Budget. OMB officials have reported that the 2013 installment of across-the-board reductions in federal appropriations will total $109 billion.

Under the Budget Control Act, these spending cuts will be evenly divided between defense and most non-defense programs. Social Security, Medicaid, and certain programs assisting low-income individuals are exempted from the cuts. In addition, Medicare spending reductions under sequestration are capped at two percent and will apply only to health care providers.

The House earlier this year passed legislation to protect defense programs from sequestration, instead reducing spending only on non-defense programs. Senate

Majority Leader Harry Reid (D-NV) announced that the Senate would not accept the House bill, and White House officials said that President Obama would veto the bill.

Other fiscal cliff spending issues include a scheduled 27-percent reduction in Medicare physician pay rates that will be effective January 1, 2013, and expanded unemployment benefits that will expire on December 31, 2012. White House and Congressional leaders are expected to address Medicare physician pay rates in any lame duck agreement; a "doc fix" measure has been adopted every year since 2003 to avoid implementing scheduled reductions in Medicare spending. An extension of expanded unemployment benefits also could be part of the lame duck negotiations.

Status of tax reform

While Congress is not expected to act on tax reform this year, the results of the 2012 election and actions taken during the lame duck session will affect efforts by the next Congress to enact tax reform legislation. It remains uncertain whether any lame-duck session agreement on fiscal cliff issues might set forth a tax reform framework or process for the next Congress to follow.

President Obama is expected to build on the business tax reform framework that the White House and the Treasury Department released in February. That plan calls for a top corporate rate of 28 percent, an enhanced domestic manufacturing tax deduction, a permanent research credit, and a tightening of US international tax rules. For more information on the Administration's tax reform proposals, see the February 22, 2012 "WNTS Insight - Obama Administration releases business reform framework." House Republicans earlier this year approved a budget resolution calling for a top corporate rate of 25 percent and movement toward a territorial tax system.

Both President Obama and Congressional Republicans have indicated that corporate tax reform should be achieved on a revenue-neutral basis; President Obama has included some business tax increase proposals in separate deficit reduction plans. In the area of individual taxes, President Obama has offered several proposals to increase taxes on higher-income individuals as part of deficit reduction efforts, while the House budget resolution calls for replacing current tax rates with two brackets of 10 and 25 percent.

The House on August 2 approved a statutory process for Congressional consideration of tax reform in 2013 that was included in its individual tax rate extension bill. Under this tax reform process proposal, a "comprehensive tax reform bill" is to be introduced by April 30, 2013 by the chairman of the Ways and Means Committee. This bill would be granted expedited consideration in the House and Senate if the initial bill is certified to achieve certain specified policy goals that include a top rate of 25 percent for individuals and corporations and moving to a territorial tax system. The House tax reform process bill would still provide at least one 60-vote threshold for Senatcoe approval of a tax reform bill.

A Republican-controlled House tax reform bill next year would be expected to build upon the international tax reform discussion draft released by Ways and Means Chairman Camp in October 2011. For more on Chairman Camp's tax reform proposals, see the November 1, 2011 "WNTS Insight - Ways and Means Chairman Camp releases discussion draft for corporate rate reduction; territorial tax system."

Senate Finance Committee Chairman Max Baucus (D-MT) in June outlined his general principles for tax reform. Chairman Baucus stated that tax reform should be centered on goals of "job creation from broad-based growth, competitiveness, innovation, and opportunity." Speaking at a Bipartisan Policy Center forum, Chairman Baucus also stated that the current tax code does not raise enough revenue and that any tax reform must be developed with a sound budget in mind that reduces the federal deficit and debt. Noting the ongoing series of tax reform hearings and discussions with other policymakers, Chairman Baucus stated that he is "making progress on a detailed tax reform proposal that will attract bipartisan support."

Tax policy personnel changes

Treasury Secretary Timothy Geithner has indicated publicly that he does not plan to serve in the second term of the Obama Administration, although he is expected to serve through the lame duck session. IRS Commissioner Doug Shulman is scheduled to end his five-year term on November 9. Nominees for both positions are subject to Senate confirmation.

There are several vacancies on the House and Senate tax committees to fill as a result of retirements and the election results. Assuming no change in the ratio of Republicans and Democrats, the House Ways and Means Committee will have three open Republican seats and two open Democratic seats, and the Senate Finance Committee will have two open Democratic seats and two open Republican seats.

Ways and Means Committee departures:	
Rep. Wally Herger (R-CA)	Retiring
Rep. Geoff Davis (R-KY)	Resigned July 31, 2012
Rep. Rick Berg (R-ND)	Ran for U.S. Senate; race undecided
Rep. Pete Stark (D-CA)	Defeated in House re-election race
Rep. Shelley Berkeley (D-NV)	Defeated in Senate race

Senate Finance Committee departures:	
Sen. Kent Conrad (D-ND)	Retiring
Sen. Jeff Bingaman (D-NM)	Retiring
Sen. Olympia Snowe (R-ME)	Retiring
Sen. Jon Kyl (R-AZ)	Retiring

Let's talk

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