

January 9, 2013

Practice Group:
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Law

Fiscal Cliff II: What's Next For Tax Reform? *Out of the Frying Pan, Into the Fire*

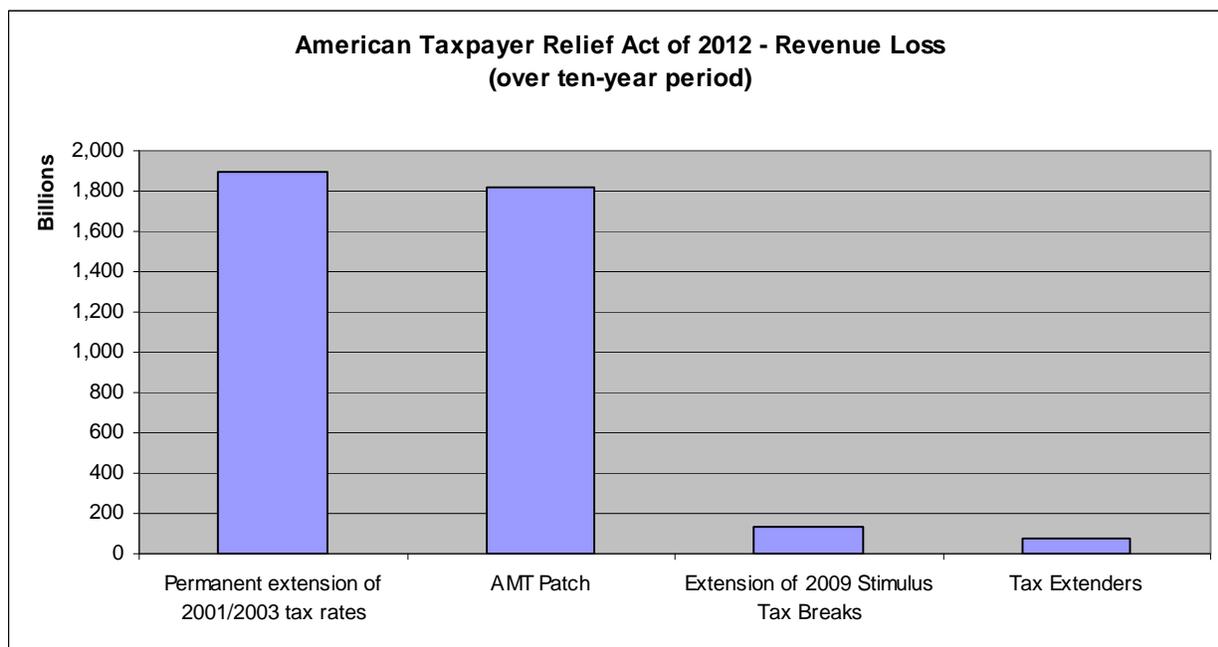
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On January 1, 2013, the Senate and House of Representatives passed the American Taxpayer Relief Act of 2012 ("ATRA"), signed into law by President Obama on January 2. ATRA averts the "fiscal cliff" by making permanent the 2001/2003 tax rates for individuals with taxable incomes less than \$400,000 and couples less than \$450,000, extending dozens of temporary tax provisions, permanently patching the Alternative Minimum Tax ("AMT"), and delaying the implementation of across-the-board spending cuts known as budget sequestration. These, and other highlights of the legislation, are listed below.

- **Permanent tax rates:** Permanent extension of the 2001/2003 tax rates for individuals with taxable incomes less than \$400,000 per year and for joint filers with taxable incomes less than \$450,000, while allowing the 2001/2003 tax rates for taxpayers over the thresholds to expire.
- **New top tax rate:** Reinstating a top rate of 39.6 percent for individuals with taxable incomes above \$400,000 and couples with taxable incomes above \$450,000.
- **Capital gains/dividends:** Permanent 15 percent rate for those below the \$400,000/\$450,000 taxable income threshold, 20 percent for those above.
- **Estate tax:** Permanent 40 percent rate, with a \$5 million per person exemption adjusted for inflation.
- **AMT:** Permanent patch, indexed for inflation.
- **Unemployment insurance:** One-year extension of additional benefits.
- **Medicare "doc fix":** One-year patch.
- **Tax extenders:** One-year retroactive extension (2012) and one-year prospective extension (through 2013) of temporary business and individual tax provisions. Business provisions include the Research and Development Credit, the Production Tax Credit for wind energy, 50 percent bonus depreciation, the active financing exception and the controlled foreign corporation look-through rule. Individual provisions include the income exclusion for discharge of mortgage indebtedness, deductions for private mortgage insurance premiums, and payments for qualified tuition expenses.
- **Personal exemption phaseout (PEP) and itemized deduction limitation (Pease):** Reinstated for individuals with adjusted gross incomes of at least \$250,000 per year and couples of at least \$300,000 per year.
- **"Stimulus" tax credits:** Five-year extension of current American Opportunity Tax Credit, Child Tax Credit, and Earned Income Tax Credit rates.
- **Roth IRA Conversion:** Permits conversion of certain pre-tax retirement savings accounts to Roth IRAs, even if not otherwise eligible for distribution.
- **Farm Bill:** General extension of farm policy through September 30, 2013.
- **Sequester:** Two-month delay of spending cuts.

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Although ATRA prevented the country from going over the fiscal cliff, the Act was not the “grand bargain” to reduce the deficit that the President and Congress initially sought. It did not reduce net spending. In fact, it actually increased the federal deficit by \$3.9 trillion, mainly by making most 2001/2003 individual tax rates permanent and by permanently patching the AMT. The following chart demonstrates how key measures in the legislation are estimated to affect the deficit over the next ten years.



The costs of these “big ticket” items demonstrate that President Obama is prioritizing his legislative agenda generally at the potential expense of high income earners. The permanent extension of the 2001/2003 tax rates, the AMT patch, and the renewal of various individual tax expenditures primarily benefit middle and lower income taxpayers, while high income taxpayers now face the first significant tax increase since 1990. Other high priority goals of the Obama Administration, such as several energy tax provisions, were renewed as part of ATRA.

Because it did not address spending and only delayed sequestration, ATRA left significant unfinished business that the 113th Congress must consider in the near-term.

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What Comes Next?

Several major events and deadlines are looming in the next two to three months:

- January 21, 2013: Inauguration address.
- January/February 2013: State of the Union address.
- February 2013: Secretary Geithner steps down?
- February/March 2013: Federal government hits debt ceiling. Although the U.S. technically hit the debt ceiling on December 31, 2012, the Treasury Department's "extraordinary measures" allow for approximately two to three more months of additional federal funding.
- February/March 2013: President releases Fiscal Year 2014 budget request.
- March 1, 2013: Budget sequestration takes effect for remainder of 2013.
- March 27, 2013: Continuing resolution funding the federal government expires.

The federal debt ceiling, budget sequestration, and the expiration of the continuing resolution funding the federal government comprise what could be called the "Fiscal Cliff II," a debate that is expected to be contentious because of clear lines already being drawn in the sand by Republicans and Democrats. Both spending and revenues are likely to be on the table. Given their recent concessions on tax increases, Republicans assert that deficit reduction must come from spending cuts, and that additional tax increases to reduce the deficit are not an option. In contrast, Democrats, including the President, continue to support an approach that includes additional tax revenues as well as spending reductions. Entitlement programs are likely to be the center of focus for reductions to spending, perhaps by switching to a "chained" CPI index projected to slow the rate of increase in benefits, or through increases in the eligibility age for benefits. Tax expenditures and "loopholes" will be scrutinized to determine whether they should be eliminated – with Republicans saying any savings should be applied to lower tax rates through tax reform, while Democrats may want to apply the savings toward deficit reduction, at least in part.

A framework for tax reform, including consideration of whether certain tax expenditures should be eliminated or temporary tax provisions should be discontinued could be a key aspect of the resolution of the Fiscal Cliff II. Such a framework could include tax reform goals, such as targeted lower marginal tax rates, timelines, and consequences if an agreement is not reached.

Either way, whether used to pay for deficit reduction or lower tax rates, tax expenditures are at high risk of being put on the chopping block.

What Will Tax Reform Look Like?

Comprehensive tax reform was not part of ATRA. However, the President, House Ways and Means Committee Chairman Dave Camp (R-MI), and Senate Finance Committee Chairman Max Baucus (D-MT) continue to express their support for tax reform, increasing the likelihood that it may be considered in legislation addressing Fiscal Cliff II. Chairman Camp has stated that he is still committed to pursuing comprehensive tax reform in 2013 while also addressing the nation's deficit and debt through spending reductions. Additionally, after passage of the bill in the Senate, Chairman Baucus said that he would proceed with an overhaul of the tax code that raises revenue to reduce the federal deficit.

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Although individual tax rates have been made permanent, some individual provisions, as well as corporate (including international) and pass-through entity tax issues remain very much in play. Shortly after passage of ATRA, President Obama announced that additional spending cuts and additional tax revenue from top income earners would be necessary to solve the nation's fiscal crisis. Tax reform may address the deductibility or tax deferred benefits of retirement savings, or cap deductions for individuals and business entities. Moreover, changes to large individual tax expenditures, such as the mortgage interest deduction, may be considered.

Corporate tax expenditures will be the most at risk because of their revenue potential and because they are easily identifiable and measurable. Pass-through entities are another likely target, either through entity level taxation or changes in taxation of pass-through profits, like carried interest, which will affect both businesses and individuals.

The political landscape following ATRA will strongly impact the direction of tax reform. President Obama and Chairman Baucus have stated that tax reform should raise revenue in order to reduce the federal deficit. Meanwhile, Chairman Camp and other Republicans argue that tax reform should be revenue neutral, and that a Fiscal Cliff II deficit reduction compromise should focus exclusively on spending cuts. The public's opinion of each party and the potential effect of a Fiscal Cliff II deal on the economy will also affect the composition of a tax reform package.

Personnel changes in the Administration and Congress also will influence tax reform. Secretary Geithner is expected to step down from his position shortly, leaving a vacancy that may not be filled by the time Fiscal Cliff II negotiations occur. New members of the tax writing committees, such as Senators Pat Toomey (R-PA) and Rob Portman (R-OH), will bring new perspective to the tax reform debate. The Fiscal Cliff II is also the first important political test for new members of Congress, and their stances on deficit reduction and tax reform will be closely examined. Finally, difficult political challenges for House Republican leadership, such as the "Plan B" fiscal cliff bill and criticism for Hurricane Sandy relief, will force House Republican leadership to carefully weigh tax reform proposals against potential political consequences during the Fiscal Cliff II negotiations.

Conclusion

ATRA's failure to be the hoped for "grand bargain" means that Congress and the President must act quickly to resolve the debt ceiling crisis, the impending budget sequester, and the expiration of federal funding in late March. Tax policy writers will look to the tax code as a source of revenue to fund deficit reductions or offset the cost of lowering tax rates. Options that generate substantial revenue without affecting tax rates, such as the elimination of tax expenditures and tax "loopholes," will be at the top of the list.

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