Gliding Off the Fiscal Cliff Towards Taxmageddon

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I. INTRODUCTION

Depending upon whom you ask, the United States is either headed towards a "fiscal cliff" or "taxmageddon."[2] Either way, the prospects are not good. This dire future is due to a combination of factors, perhaps most importantly the 2008 financial crisis and resulting recession. However, recent tax policy missteps have contributed to the issue, including the temporary extension in 2010 (through the end of 2012) of the 2001 tax rate reductions, the automatic spending cuts that were enacted as part of the "debt ceiling" standoff in the summer of 2011, and the temporary (through the end of 2012) reduction in the payroll tax rate.

Hence, without further Congressional action, income tax and payroll tax rates will rise and automatic spending cuts will begin in January 2013, endangering a fragile economic recovery. After a brief review of how we got to this point, this article will then discuss the prospects for avoiding the fiscal cliff/taxmaggedon.

II. BACKGROUND – 2010 LEGISLATIVE CHANGES AND ELECTION

A. The Legislative Environment

The so-called "Bush-era tax cuts," passed in 2001 and 2003, were set to expire on December 31, 2010, because they were passed as part of a budget "reconciliation measure" (since the Republicans only had a slight majority) which cannot be filibustered.[3] A bill can only be pushed through by reconciliation, however, if it would *not* add to the deficit at the end of ten years; thus, the "sunset" provision in the Bush-era tax legislation meant that the deficit was calculated as if the higher tax rates would be in effect January 1, 2011 (interestingly, this was the same vehicle used to pass the recent health care bill).[4] In short, if Congress and President Obama did nothing, the Bush-era tax cuts would go away automatically on December 31, 2010, and the 2001 rates would resurrect immediately.[5] According to the White House, the average American would have seen an immediate tax increase on January 1, 2011, of $3,000.[6]

Democrats have long argued that the Bush-era tax cuts *should* go away, and President Obama vowed to end the tax cuts for the wealthy during his election campaign.[7] But after enjoying control of both the Senate and the House—which allowed the enactment of the Patient Protection and Affordable Care Act ("Obama health care bill")—the Democrats faced the 2010 midterm Congressional election where all seats in the House of Representatives and one third of Senate seats were up for election.[8] In fact, many Democrats were concerned that even the safest Senate seats (such as that of the late Edward M. Kennedy of Massachusetts) would go to a Republican as a direct political consequence of the Obama health care bill.[9]

The fears were not unwarranted; the Republican Party picked up six seats in the Senate (which became 53 Democrats, including two independents, and 47 Republicans), and more than 60 seats in the House (which became 240 Republicans to 193 Democrats). Thus, the Senate became gridlocked, Republicans assumed a majority in the House, and consequently Representative Dave Camp (Republican from Michigan) became Chairman of the Ways and Means Committee, which has sole jurisdiction over United States tax policy.[10] Representative Camp prides himself on "lowering and simplifying tax rates for individuals, families, and employers."[11] In other words, a major power shift occurred after the midterm Congressional elections and the stage was set for an epic battle.

B. 2010 Legislative Changes

Facing expiration of the Bush-era tax cuts, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("2010 Tax Relief Act") on December 17, 2010.[12] The 2010 Tax Relief Act extended the Bush-era tax cuts on individual ordinary income rates (35 percent top rate, as opposed to 39.6 percent if allowed to expire) and capital gains/dividend tax rates (15 percent) for all taxpayers until December 31, 2012.[13] Additionally, the 2010 Tax Relief Act provided for an alternative minimum tax "patch," a payroll tax cut (for one year), 100 percent bonus depreciation (through 2011) and 50 percent bonus depreciation (for 2012), a 35 percent cap on the estate tax rate with a $5,000,000 exclusion, and more.[14]

Critics concluded that the Democrats punted on the tax-cut issue because they feared further backlash from voters.[15] Moreover, President Obama faces a re-election campaign in 2012. Although he earlier vowed to end the tax cuts, President Obama personally placed numerous calls to House Democrats in December 2010 urging them to support the extension of the cuts.[16] Representative Elijah Cummings (Democrat from Maryland) voiced his concerns to President Obama in 2010 that "these tax cuts would not end in 2012, because in an election year, [it is] very, very difficult" to increase taxes; President Obama replied that the Bush-era tax cuts "would be part of his platform when he ran."[17]

If no further action is taken, the Bush-era (or the Obama-era) tax cuts will officially expire on December 31, 2012, and rates will automatically increase on January 1, 2013.[18]

III. THE DEBT CEILING STANDOFF

As 2011 began, Congressional Republicans decided to test their new power almost immediately by publicly proclaiming that they would not vote to increase the federal government's "debt ceiling," which was due to be exceeded by early August, 2011. The government's debt ceiling is an arcane rule that limits the ability of the U.S. Treasury to borrow without further Congressional authorization. For many years, Congress has voted to increase this ceiling without significant controversy.[19] Congressional Republicans stated that they would not approve this particular increase without significant changes to the government's fiscal policy. [20]

This stated refusal caused much confusion in financial markets, and immediately led to speculation as to whether the two political parties could agree to a solution. Evidently, high level negotiations between Democrats (including President Obama) and Republicans (led by House Speaker John Boehner) took place in July 2011, and came very close to agreeing on a framework of a budget deal that would include tax revenue increases and significant spending cuts in the context of an overall change to federal tax policy.[21]

However, this comprehensive deal never came to pass, and instead, at the last minute, Congress passed and the President signed the Budget Control Act.

IV. DEBT CEILING RESOLUTION—THE "SUPER COMMITTEE"

A. The Budget Control Act

The Budget Control Act permitted an increase in the debt ceiling (at least until late 2012 or early 2013), but it also effectively delegated a solution to the U.S. fiscal problem to a "super committee" made up of six Democrats and Six Republicans. The super committee was given until November 23, 2011, to come up with a comprehensive plan to reduce the U.S. federal government deficit by $1.5 trillion over 10 years. If the committee failed to produce a recommendation that garnered a majority of the committee (meaning that one member would have to "switch sides," given the even 6-6 split), then automatic spending cuts (called "sequestration") of $1.2 trillion would begin in 2013, fairly evenly split between defense spending and other types of federal spending.[22] Specifically, $492 billion would be cut from each of the defense budget and the non-defense budgets (for a total of $984 billion), and $216 billion would be saved due to reduced interest payments on the consequently lower federal debt.[23]

B. Results of Super Committee

Not surprisingly, after three months of negotiations, the super committee failed to resolve the tax legislation problem and instead "kicked the can down the road," so to speak.[24] The super committee had the rare opportunity to resolve fiscal problems by quickly moving legislation through a gridlocked Congress.[25] Democrats blamed the Republicans and Republicans blamed the Democrats for the failure, though.[26] The co-chairs of the bipartisan super committee issued a statement that "after months of hard work and intense deliberations, we have come to the conclusion today that it will not be possible to make any bipartisan agreement available to the public before the committee's deadline."[27] The super committee's failure led to, among other things, increased investor uncertainty as evidenced by the subsequent downgrading of the United States' credit rating.

If no further action is taken, the automatic spending cuts described above will commence in early 2013.[28] Both sides agree that the arbitrary cuts—commencing with $110 billion on January 2, 2013—should be replaced with a more thoughtful budget agreement, but they are diabolically divided on where to make the cuts and whether to increase taxes.[29]

V. 2011-2012 – NEW PROPOSALS

As noted above, the super committee failed in its quest to agree on a comprehensive tax and budget reform solution. However, during the super committee process, each party put forth new and fairly detailed proposals that are worthy of further detailed analysis.

A. Republican Proposals

On the Republican side, two important proposals were announced. First, in late October, 2011, House Ways & Means Chairman Dave Camp released the first part of what he called a "comprehensive" tax reform proposal. This first part is the first serious proposal to change the U.S. system of taxing international corporate income to a "territorial" system, away from the current "hybrid worldwide" approach. Then, in early 2012, Representative Paul Ryan (Chair of the House Budget Committee) put out a comprehensive budget proposal. Each is now discussed in turn.

1. *Representative Camp's "Territoriality"*

As noted, Representative Camp's proposal is meant to encompass comprehensive tax reform, including individual, corporate, and international reform.[30] So far, only the international portion of this plan has been released; however, Rep. Camp's plan does say that he would reduce the overall corporate tax rate to 25 percent (from its current 35 percent level), and that this rate reduction would be accomplished in a revenue-neutral way by broadening the corporate tax base. The individual portions of his plan are presumably similar to those put forth by Rep. Ryan (discussed below). The international provisions of his plan are summarized immediately below.

By way of background, currently U.S. corporations are taxed on their worldwide income, no matter where earned. U.S. corporations have an opportunity to "defer" U.S. taxation of foreign earnings, provided such amounts are earned by a foreign subsidiary in a manner that avoids U.S. "anti-deferral" rules (known as "Subpart F"), and such amounts are not repatriated to the U.S. This system has been criticized as creating an incentive for the retention of earnings offshore (the so-called "lockout" effect). Also, the worldwide system, when combined with a 35-percent corporate tax rate, has been criticized as putting U.S. multinationals at a competitive disadvantage.

Rep. Camp's plan would abandon the worldwide system and move the U.S. to a "territorial" system, whereby the foreign earnings of U.S. multinationals would be mostly exempt from U.S. taxation, whether such earnings were repatriated or not. Specifically, U.S. corporations would be entitled to a 95 percent dividends received deduction (DRD) for dividends received from Controlled Foreign Corporations (CFCs) in which the U.S. corporation held a 10 percent or greater interest. Likewise, the sale of CFC stock, in most cases, would be exempt from U.S. taxation. Foreign "branches" of the U.S. corporation would be treated as CFCs for this purpose.

The proposal would retain and actually strengthen the current Subpart F regime, under which certain types of income earned by a CFC is taxed, as earned, to its U.S. parent as if such income were earned directly by the U.S. parent. Subpart F would be strengthened by adding one of three possible "options" to current law, in order to deal with the increased incentive, under an exemption system, for U.S. MNCs to shift assets and income offshore. One of the options is to tax currently in the U.S. any "excess intangibles income" earned by a CFC, which is the same as the Obama Administration's proposal (discussed below). The second option would treat a CFC's income as being all Subpart F (and hence subject to U.S. tax), if the CFC's effective foreign tax rate is below a certain percentage. The final option would treat all of a CFC's income from intangible assets as being Subpart F, but only 60 percent of such amount would be subject to U.S. taxation. This last proposal would also allow the U.S. parent a deduction equal to 40 percent of its foreign intangibles income, and thus operates somewhat in the form of a "patent box" that many other nations are now adopting.

2. *Ryan Proposals*

Rep. Ryan's proposals were released in February 2012 in a document called "Path to Prosperity."[31] This proposal is a comprehensive solution to the budget and deficit program in the U.S., and hence it includes spending and taxation proposals. The taxation proposals will be discussed first, but given their importance, some mention will be made here of the overall spending framework proposed by Rep. Ryan.

On the taxation side, Ryan agrees (not surprisingly) that the international system should be moved to a territorial system, presumably the one that Rep. Camp is proposing. He also agrees that the corporate tax rate should be reduced to 25 percent. Where Ryan's proposal adds some specificity is on the individual tax side—his proposal would reduce the individual tax system to reflect just two brackets, one at 10 percent and one at 25 percent. Also, the alternative minimum tax (AMT) would be eliminated.

Interestingly, the proposal does not propose specifics with respect to capital gains and dividend tax rates. Also, the proposal offers very little in specifics as to which tax "subsidies" or expenditures would be eliminated in order to "broaden the base" to permit Ryan's system to collect at least 18 percent of GDP in revenue at such low tax rates, as he states is his goal. Rep. Ryan does make reference to a potential change in (or elimination of) the current exclusion from gross income for employer-provided health insurance, to be made as part of an overall change to the U.S. healthcare system. Supporters of Rep. Ryan's plan have indicated that there will be (unspecified) base broadening,[32] but tax policy purists cannot have been encouraged by Rep. Camp's recent statement this his plan (and presumably Rep. Ryan's) will not change the current mortgage interest deduction.[33] If the mortgage interest deduction is not "on the table," then one may wonder exactly which "subsidies" will be eliminated to pay for the reduction in tax rates.

Lastly, a brief word about Rep. Ryan's spending priorities. His budget would "cap" U.S. government spending at a particular percentage of GDP, which in his case would be 18 percent. However, while capping overall federal spending, Rep. Ryan's plan would actually increase defense spending over the next decade. To pay for this, and stay below 18 percent of GDP in spending, would require significant cuts in other areas of spending, including Medicare, which Rep. Ryan would (somewhat notoriously) put into competition with private insurers. Medicaid would be converted to a block grant to states, and other popular programs (such as the National Endowment for the Arts) would face possible elimination.

B. Administration Budget and Framework

Likewise, the Democrats have put forth a variety of proposals to reform the tax system and reduce the deficit. Many of these proposals were included in the President's 2013 Budget proposals, issued in February 2012. In addition to the Budget, the President also issued a business tax "framework" paper in late February 2012. Both are discussed below.

1. 2013 Budget Proposals[34]

The most prominent provision included in the President's budget is the proposal to increase tax rates on high earners, back to the rates in place prior to the 2001 and 2003 tax rate reductions.[35] President Obama maintains that raising taxes on the wealthy is "about the nation's welfare."[36] Likewise, the capital gains tax rate would increase to 20 percent (from its current 15 percent) for these high earners, and their dividends would also be subject to taxation at ordinary income rates (which would become 39.6 percent[37] for those in the top bracket). Further, the estate and gift tax parameters in effect in 2009 would be restored. Also, the proposal contains a number of other, smaller provisions, including a proposal to extend 100 percent bonus depreciation for another year.

On the international side, the President's Budget included a number of provisions that have been previously proposed. Most of these proposals merely tighten up the existing hybrid worldwide international tax system. The most important of these is the proposal to impose current U.S. taxation on the "excess intangibles income" earned by foreign subsidiaries of U.S. corporations. These proposals reflect an important difference between the two parties—as noted above, the Republicans want to move towards a territorial system, while the Democrats would maintain (and strengthen) the existing international tax regime.

2. The Business Tax "Framework"

The Administration's "Framework" gave further details on its views on business taxation.[38] Most importantly, the Framework states that the corporate tax rate should be reduced to 28 percent, in return for base-broadening to make up for the lost revenue. The base-broadening would include elimination of LIFO, elimination of oil & gas "tax preferences," taxing "carried interest" as ordinary income, and elimination of bonus or even accelerated depreciation.[39]

Further, the Framework would consider taxing large passthrough entities as though they were corporations.[40] Also, manufacturing income would be taxed at just a 25 percent rate, and the R&E credit would be made permanent. Lastly, there is some indication that the Framework would consider imposing some limits on the ability of corporations to deduct interest payments.

On the international side, the Framework would maintain the current worldwide hybrid international system, and would even strengthen it, in the name of preserving jobs and manufacturing activity within the U.S. The Framework's major international contribution (in addition to the Budget proposals noted above) is to propose imposition of a "minimum tax" on the overseas profits of U.S. MNCs. Presumably, this would look something like the system in Japan, where the earnings of a CFC are taxed currently in the home country if the CFC's effective foreign tax rate is below a certain number (say 10 or 20 percent).

VI. 2012 LEGISLATIVE ACCOMPLISHMENTS (OR LACK THEREOF)

After the failure of the super committee, and with a presidential election on the horizon, hopes were not high for legislative accomplishments during 2012. After one of the most contentious fiscal policy battles of the 112th Congress, on February 10, 2012, Congress extended the payroll tax cuts and unemployment benefits which were set to expire from the 2010 Tax Relief Act.[41] The bill kept, among other things, a two percentage-point payroll tax cut for 160 million wage-earners through the end of 2012, provided additional unemployment benefits, and protected doctors who receive Medicare payments from a cut in reimbursements.[42] Both Republicans and Democrats claimed it as a "win," although the Democrats likely carried the day as Republicans gave up on having the tax cuts be paid for and the cuts will simply further increase the deficit.[43] According to the Congressional Budget Office, the bill increased the deficit by $126 billion over the next five years.[44] Speaker of the House John Boehner (Republican from Ohio), supported the bill but added, "[L]et's be honest, this is an economic relief package, not a bill that's going to grow the economy and create jobs;" moreover, many of the provisions in this bill, and the other bills passed during President Obama's tenure, are set to expire at the end of 2012.[45] Thus, the members of the 112th Congress still have a lot of work to do and the upcoming elections are paramount.

VII. CONCLUSION—A MURKY FUTURE

As can be readily seen from the above summary of proposals, and the lack of progress in 2012, Democrats and Republicans remain far apart on a variety of tax policy positions. In particular, Republicans oppose the Administration's ideas on taxing large pass-throughs as corporations, and taxing carried interests as ordinary income. But probably the biggest area of difference is in the international arena—Republicans are now committed to a move to a territorial international tax system, whereas the Administration is committed to maintaining and strengthening the current hybrid worldwide system.

However, there are some broad areas of agreement. Both parties agree on the need for a lower corporate tax rate, for example. Also, interestingly, both agree (at least in principle) on the need for stronger rules to tax the international IP-related income of U.S. MNCs.

Where all agree is that there will be no further action of any significance prior to the 2012 elections.[46] After the 2012 elections, there is likely to be a "mad scramble" to implement some sort of compromise to prevent an automatic increase in the income and payroll tax rates, and automatic spending cuts, all of which will take place unless there is further Congressional action.[47] Also, various other expiring provisions (called "extenders"), including the AMT "patch," will require attention before year end.

Hence, early 2013, before Congressional attention turns to the 2014 mid-term election, may be the best time for comprehensive tax reform. At least some members of Congress see the need for comprehensive change,[48] and the framework that was temporarily agreed in the summer of 2011, plus the Obama and Camp proposals described above, give some idea as to the form that the ultimate compromise will take. The question will be this: what mix of revenue increases (if any) and spending cuts will eventually be agreed to in order that the deficit (and resulting growth in U.S. federal debt) finally begins to moderate.

ENDNOTES

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6. *Id.*

7. *See* Bush-Era Tax Cuts, New York Times Topics, available at: http://topics.nytimes.com/top/reference/timestopics/subjects/t/taxation/bush_tax_cuts/index.html; *see also* Lori Montgomery and Shailagh Murray, *Congress votes to extend Bush-era Tax cuts until '12,* The Washington Post, December 17, 2010, available at: http://www.washingtonpost.com/wp-dyn/content/article/2010/12/16/AR2010121606672.html.

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15. Lori Montgomery and Shailagh Murray, *Congress votes to extend Bush-era Tax cuts until '12*, The Washington Post, December 17, 2010, available at: http://www.washingtonpost.com/wp-dyn/content/article/2010/12/16/AR2010121606672.html.

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29. Janet Hook and Damian Paletta, *House Bill Shields Defense From Cuts*, Wall Street Journal, May 8, 2012.

30. Rep. Camp's proposal is called a "Discussion Draft" and is available at the House Ways and Means Committee website here: http://waysandmeans.house.gov/taxreform/.

31. Rep. Ryan's document is available on the website of the House Budget Committee and can be found here: http://budget.house.gov/UploadedFiles/Pathtoprosperity2013.pdf.

32. Furchtgott-Roth, *Battle of the Budgets,* Tax Notes, April 2, 2012, at 105.

33. Rothman & White, *Camp Not Looking at Mortgage Interest Deduction as Romney Backs Off Comments,* Bureau of National Affairs (BNA) Tax Daily, April 17, 2012.

34. The Administration's Budget is available on the White House website here: http://www.whitehouse.gov/omb/budget.

35. John D. McKinnon, *Top 1% Would See $90,000 Tax Rise, Report Says*, Wall Street Journal, March 23, 2012 (President Obama proposes $1.4 trillion in tax increases over 10 years for "higher earners" (couples making more than $250,000)).

36. *Id.*

37. The tax rate on dividends would actually be higher than 39.6% if the imposition of a Medicare tax on certain levels of passive income, which was enacted as part of Mr. Obama's 2010 health care overhaul, takes effect as scheduled in 2013.

38. The Framework is available online here: http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf/

39. On this last issue, the Framework is inconsistent (at least temporarily) with the President's own budget, which has proposed extension of 100 percent bonus depreciation through 2013.

40. There is some indication that "large" passthroughs in this context mean those with gross receipts in excess of $25 million.

41. *See* Robert Pear and Jennifer Steinhauer, *Tax Cut Extension Passes; Everyone Claims a Win*, The New York Times, February 17, 2012 (It was the second bill in the 112th Congress to be split by party lines; the other being a spending bill.).

42. *Id.*; *see also* Annie Lowrey, *Tax-Cut Bill Includes Updates to Jobless Benefits System*, The New York Times, February 21, 2012.

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45. Jason Linkins, *John Boehner Upset That the Payroll Tax Cut Extension Means Ordinary Americans Will Have More Money*, The Huffington Post, Politics, February 17, 2012.

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47. This prediction has been made by many, including George Callas, Staff Director, Subcommittee on Select Revenue Measures, House Committee on Ways and Means, in a conference call that he held with the State Bar of California Taxation Section on April 19, 2012.

48. Bai, *supra* note 21, at 47 (citing a statement by Speaker Boehner that the U.S. is "heading toward a very bit moment, where big decisions are going to have to be made about the future of our country").