

Tax policy decisions ahead.

President-elect Obama's call for change

November 2008



Overview

On November 4, the nation voted to hand over to President-elect Barack Obama, and a strengthened Democratic Congress, a seemingly intractable set of long-term budget and tax issues. Given these challenges, the policy decisions Obama and Congress make in 2009 and 2010 will go far in determining the fiscal and economic course the country will take going into the next decade.

When the presidential campaign started in the spring of 2007, most serious observers of Washington had long since concluded that the tax and spending commitments of the United States are unsustainable beyond the end of the next decade. Since then, a significant economic downturn and extraordinary government spending associated with efforts to promote recovery may have accelerated the potential day of reckoning.

The presidential campaign, however, seems to have given structure to the debate over spending and taxes in four important respects. First, both candidates agreed that a return to budget discipline is required. Second, neither side suggested that it is yet time to address the long-term budget challenges caused by growing Social Security and Medicare entitlements. Third, they both agreed that overall tax increases should not play a major role in reducing current deficits and that the expiration of the Bush tax cuts in 2011 must be addressed with a permanent solution. Finally, and as a result, both presidential candidates promised spending discipline designed to bring the budget into balance in the near term.

With respect to tax policy, Obama and Republican presidential candidate Sen. John McCain of Arizona differed significantly regarding the details of what they would do, but nonetheless appeared to agree on the fundamentals of what to tax and, more generally, how much total tax to collect. Large pieces of the President-elect's agenda will enjoy bipartisan support while other parts may encounter bipartisan opposition. What is clear is that neither the President-elect nor Congress plans to dramatically increase the total tax collections of the federal government.

Moreover, the current economic climate will make tax increases and spending cuts in the near term more difficult and, perhaps, less advisable. The new administration and Congress will hesitate in taking any action that can be seen as further suppressing economic activity. In addition, they may wish to undertake new spending to stimulate the economy and will find that safety-net spending by the federal government for unemployment and other benefits rises automatically as the economy weakens.

Tax policy decisions ahead

Tax policy decisions ahead: President-elect Obama's call for change focuses on the likely tax agenda for 2009 and 2010, which may unfold in two distinct pieces. The first could be tax cuts focused on economic recovery and other stimulus actions meant to address the current economic downturn. The second could be a package of tax proposals to address the longer-term issues that were raised in the campaign.

This publication summarizes the broad outlines of the President-elect's tax plans as discussed during the campaign and looks at the broad challenges for moving that agenda through Congress. It then examines in more detail the proposals for changes in the income taxation of businesses and individuals, their potential impact on taxpayers, and ways in which taxpayers could consider preparing for coming change.

A series of tables at the end of the publication highlights Obama's core tax proposals, his temporary economic stimulus proposals, major revenue-raising options that Obama and the Democratic Congress are likely to consider to pay for tax relief, prospects for the expiring Bush tax cuts, and possible changes to individual income tax rates under Obama's proposed tax plan.

Obama's tax proposals

President-elect Obama's core tax plan follows the Democratic orthodoxy of increasing taxes on the wealthy to pay for tax cuts and other benefits for low- and middle-income taxpayers. For individuals, he has promised a return to tax policies more similar to those of the Clinton administration by:

- Making the tax cuts adopted in 2001 permanent for all but higher-income taxpayers;
- Restoring the Clinton-era top rates for individuals making more than \$200,000 and couples earning more than \$250,000;
- Adding an array of targeted tax relief provisions for middle- and lower-income individuals;
- Providing an estate tax exemption of \$3.5 million per person and an estate tax rate of up to 45 percent; and
- Raising taxes through eliminating "loopholes" and other largely unspecified special interest tax provisions.

Notably, Obama's campaign did not focus extensively on business tax reform other than to identify targeted areas for raising revenue. He expressed support for lowering the top corporate tax rate from 35 percent to an as-yet unspecified rate, and offsetting the cost through specific revenue raisers and other unidentified "loophole" closers totaling an estimated \$76 billion per year. Some possible offsets highlighted during the campaign include eliminating oil and gas tax

incentives, codifying the economic substance doctrine, modifying Subpart F deferral to “end incentives for companies to ship jobs overseas,” taxing certain publicly traded partnerships as C corporations, and taxing carried interests as ordinary income. Obama’s policies, according to the nonpartisan Tax Policy Center, would amount to an increase in business-related taxes of \$770 billion.

Compared to the revenue that would result from simply extending 2008 tax law indefinitely, Obama’s campaign proposals, taken together, would reduce individual income taxes below present-law levels while increasing total taxes by \$617 billion over 10 years. In the aggregate, this would represent less than a 2 percent increase in total federal receipts. If President-elect Obama is to keep his campaign promise to balance the federal budget, it is apparent that significant reductions in federal spending will have to occur.

In addition, the President-elect has called for immediate tax relief and other measures intended to assist the economic recovery. For businesses, Obama would provide a refundable \$3,000-per-employee credit for employment of additional full-time workers in the U.S. and extend the \$250,000 expensing allowance for small business through 2009. With respect to IRAs and 401(k)s, Obama would permit penalty-free hardship withdrawals from retirement accounts in 2008 and 2009 and suspend the mandatory distribution rules for those who have reached age 70½ (or exempt those distributions from tax for accountholders that elect to take them). He also would accelerate the effective date of a number of his basic tax proposals.

Outlook for working with Congress

Between now and the submission of its first budget in February 2009, the Obama administration will confront the hard work of converting campaign rhetoric and promises into actionable legislative proposals. Obama will come into office with a supportive Democratic Congress that has significantly increased its majority in both chambers. Part of that congressional election victory may well be attributable to Obama’s broad electoral success; nonetheless, as is always the case, the new president will find that even a friendly Congress has a mind of its own. An important early decision for the new administration will be to identify its top priorities for its first six months. These initiatives could define the relationship between the White House and the Congress for the remainder of the president’s time in office.

On the domestic front, Obama had generally been expected to make health care reform his first major legislative initiative. In recent weeks, however, Obama and the country have shifted their attention toward the economic crisis and the possibility of a further economic stimulus package, which could include temporary targeted tax provisions as well as the extension of unemployment benefits and assistance to states.

The current fiscal situation may affect the timing of Obama’s longer-term tax agenda. For example, although ordinary, capital gains, and qualified dividend tax rate increases on high-income individuals were widely discussed in the campaign, the new administration and Congress may conclude that immediate action on many of these proposals that would raise taxes are unnecessary or undesirable in a time of economic uncertainty.

Similarly, pursuing a significant reform of business and international tax rules may not be inviting as an early initiative. At the same time, the fiscal year 2008 budget deficit ballooned to over \$450 billion and is widely expected to be substantially higher in the current fiscal year. This, in turn, may increase pressure to raise offsetting revenue for any new or extended business tax relief.

Regardless of how the new administration chooses to begin its legislative agenda, the long-term outlook is clear on some issues. First, the significant budget shortfalls will restrict the spending and tax programs that the Obama administration can ultimately shepherd through Congress. Second, the core components of Obama’s campaign proposals likely will become law in 2011 at the latest. This would include extension of the current tax brackets and rates for low- and middle-income taxpayers, a return to higher ordinary and capital gains rates for individuals with incomes over \$200,000, and married couples with incomes over \$250,000, actions to protect middle-class taxpayers from the individual alternative minimum tax (AMT), and restrictions on certain tax benefits and incentives.

The work that is done in 2009 and 2010 may well determine the size and shape of our income tax systems for the foreseeable future. Once that work is completed, however, Congress likely will not have enough revenue to meet the long-term demands that we have placed on the federal government. Even before the recent economic downturn, credible projections of the federal budget suggested that if the country were to continue on its current budget path, annual deficits would exceed any reasonable expectation of economic growth by the middle of the next decade. This would result in an unsustainable increase in debt held by the public, which would exceed 100 percent of gross domestic product before the end of the third decade of this century.

These long-term deficits will force consideration of major reforms to Social Security and Medicare entitlement spending, as well as an additional federal levy to meet new needs or prevent additional entitlement cuts. If the tax structures of our global competitors are a guide, then this new levy could be some kind of a consumption tax. The question will be whether that tax will be a broad-based consumption tax burdening the purchase of most goods and services, or whether it will be more narrowly focused on specific forms of consumption such as consumer goods, energy, or carbon.



Business taxes

On the surface, President-elect Obama's discussion of corporate and business taxes during the campaign might have created some confusion. He did not propose increasing corporate tax rates as he had for high-income individuals. Indeed, he proposed cutting the rates for some start-up companies and was open to discussion of lower corporate rates more generally. At the same time, Obama called for significant tax increases through specifically identified measures affecting business and through a dramatic level of unidentified measures that he said would "broaden the corporate tax base and eliminate special interest loopholes." The net effect of these policies, according to Tax Policy Center estimates, would be an increase in business-related taxes of \$770 billion over 10 years. Although these proposals are not limited to the corporate income tax, their sheer scale is illustrated by the fact that \$770 billion would represent nearly 20 percent of projected corporate tax receipts for the 10-year period.

Much of the detail that business needs to effectively defend against, or plan for, likely tax increases is not yet available. Adding to the uncertainty for business is a growing consensus that the U.S. corporate statutory rate should be reduced. The current U.S. corporate tax rate of 35 percent — approximately 39 percent when average state and local corporate income taxes are considered — is second only to Japan among the 30 members of the Organisation for Economic Cooperation and Development (OECD). The average corporate income tax rate of OECD member nations is approximately 27 percent. As this debate moves forward, the discussion will move to how, or whether, the revenue lost by lowering the corporate rate should be recaptured by other measures.

Although Obama is not coming into office with a tax plan as detailed as those of Ronald Reagan in 1981, Bill Clinton in 1993, or George W. Bush in 2001, we can nonetheless look to his various campaign proposals to understand the direction that he and Congress may take as they address business and corporate taxes.

The four dominant and interrelated themes struck by the campaign were:

- Protecting and growing U.S. jobs;
- Changing how we produce and use energy;
- Restoring "fairness" to the tax code; and
- Providing quality health care.

Obama made specific proposals in each of these areas that offer useful insight into the new administration's thinking and can serve as a guide in identifying additional proposals that may attract its support.

Protecting and growing U.S. jobs

President-elect Obama campaigned on creating jobs in the U.S. and limiting tax benefits of companies that "retain their earnings overseas" or "ship jobs overseas." His approach combines carrots for U.S. job creation and investment with sticks aimed at companies investing abroad.

On the incentive side, Obama proposes to:

- Reduce the corporate tax rate for companies that start or expand operations domestically, although he has not specified what the new rate should be;
- Eliminate all capital gains taxes on small business investments and for start-ups;
- Encourage innovation, and the jobs related thereto, through a permanent extension of the research and experimentation tax credit, which is currently scheduled to expire once again at the end of 2009; and
- Encourage rural community development and employment through loan and tax incentives for community broadband. The details of this plan have not been described.

As part of his short-term economic stimulus package, Obama would establish a New American Jobs Tax Credit during 2009 and 2010, which would provide existing businesses that make net additions to their U.S. workforce a \$3,000 refundable tax credit for each additional full-time employee hired. He also would extend the temporary increase in the small business expensing allowance to \$250,000 through 2009.

With talk of another stimulus package, some in Congress and the business community will likely push for inclusion of business tax provisions that have been enacted or discussed before. These include bonus depreciation, which has been used several times since 2001, or the extension of the election for corporations to increase their business credit or AMT limitation in lieu of bonus depreciation, which was included in the Housing and Economic Recovery Act of 2008. Other possibilities are extension of the net operating loss carryback period, which was included by Senate Democrats in stimulus plans in early 2008, and a temporary repatriation holiday like that of section 965, which was part of the American Jobs Creation Act of 2004.

In contrast to his stimulus proposals, which seek to encourage U.S.-based economic activity, Obama has promised to raise taxes on U.S. companies that operate abroad. On the campaign trail, Obama did not discuss international tax reform in any detail, suggesting that the policy debates and consensus building required before any administration can present major international tax reforms has not occurred among his advisors in a substantive fashion. Additional tax advisors likely will be joining the Obama team to develop the details of these proposals.

Nonetheless, the general options for addressing the taxation of U.S.-based multinational taxpayers are well understood. The most dramatic of these would be either to repeal deferral or adopt a form of territorial taxation, neither of which appears to be a likely outcome based on the political environment and the long history of failed international tax reform efforts to date. An analysis of recent proposals reveals a host of options between these two extremes, including limitations on deferral, foreign tax credits, and international tax planning strategies. These are options that the Obama administration is bound to consider:

Indirectly limit deferral — Although repeal of deferral is unlikely, Obama has said that he would “modify these rules to discourage “shipping jobs overseas.” An example of an approach that stops short of repealing deferral is a proposal in House Ways and Means Committee Chairman Charles Rangel’s 2007 tax reform legislation to limit the deduction of expenses allocable to foreign income until that income is repatriated, thereby increasing the cost of deferral. At the time, then-Sen. Obama expressed support for Rangel’s proposal to change the allocation of deductions by international businesses. However, the same political forces that make repealing deferral unlikely also make indirectly increasing the cost of deferral a difficult option for a new administration to achieve.

Limit foreign tax credit benefits — In the past, significant international reforms have included reengineering of the foreign tax credit limitations. Currently, the tax law contains foreign tax credit provisions that limit the credit with respect to specific categories of earnings derived by separate subsidiaries. Rangel proposed an overall foreign tax credit limitation that would significantly reduce a taxpayer’s ability to avoid double taxation of income on dividends from foreign subsidiaries. Although attacks on foreign tax credits would be vigorously resisted on both theoretical and practical grounds, any future international tax reform proposals are likely to contain at least some modest adverse measures restricting the ability to utilize foreign tax credits.

Limit specific international tax planning strategies — The most likely changes to be pursued by the new administration are targeted attacks on offshore operations of U.S.-based multinationals. For example, the Obama campaign suggested establishing an international “tax havens watch list,” and tax administrators around the globe continue to express concern over the transfer pricing treatment of intellectual property and other intangibles. To the extent that the new administration can fairly characterize proposals as preventing abuse or closing loopholes, they would receive a more favorable reception on Capitol Hill.

Don’t ignore international tax planning opportunities

President-elect Obama’s focus on international tax and on creating incentives for U.S. employment raises a number of questions regarding potential changes in this area. In fact, there is little that is fundamentally new in this discussion.

For example, many of Obama’s ideas can be traced back to a 1992 series of tax reform options identified by then-House Ways and Means Committee Chairman Dan Rostenkowski.

Although the new administration and Congress may turn their attention to international reforms, changes will not come rapidly and may come only incrementally. Taxpayers who delay international tax planning opportunities while they wait for resolution of these issues likely will find that they have lost important tax benefits in the process.

Changing how we produce and use energy

President-elect Obama has put forward a series of energy-related tax proposals intended to affect both the country’s investment in various types of energy production and our choices about consumption. Again, Obama’s energy tax policy consists of carrots and sticks. It also leaves some important issues unaddressed.

Oil and gas incentives — In response to the high oil prices that accompanied much of the presidential campaign, Obama proposed a windfall profits tax on oil companies that would be used to fund “emergency energy rebates” to individuals (\$500) and families (\$1,000). In addition, Obama would repeal the section 199 domestic production deduction for income attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product derived from them. In the past year, various bills in Congress would have repealed or modified the amortization of geological and geophysical costs, extended recovery periods for gas distribution or gathering lines, and imposed an excise tax on oil or gas extracted from leases on the Outer Continental Shelf. Each of these proposals could be taken up by the new administration.

To encourage investment in renewable fuels, Obama has proposed a five-year extension of the credit for electricity produced from renewable resources (section 45). With respect to consumption, the campaign proposed a \$7,000 tax credit for the purchase of an advanced technology vehicle and \$4 billion in loan guarantees and tax credits for the retooling of domestic auto plants and parts manufacturers to produce new fuel-efficient cars.

These energy credit proposals are striking for their selectivity. Although the campaign's official documents are limited in their scope, as a senator, Obama sponsored or cosponsored numerous proposals to encourage both alternative and renewable fuels and greater energy efficiency. The challenge for his administration will be to lead in crafting a coherent energy tax policy that persistently encourages renewables and alternatives while recognizing that oil, gas, and coal will necessarily continue to play a central role in meeting U.S. energy demand.

Uncertain environment will require business decisions

With continued uncertainty over the economic downturn, unstable financial markets in the U.S. and abroad, and projected long-term budget deficits, significant changes to corporate tax law are likely and the business community should remain vigilant.

President-elect Obama has committed to substantial corporate revenue raisers, although specific provisions are as yet largely unidentified. Moreover, revenue raisers do not need to await a major tax bill. They could arise early in 2009 to pay for other legislation.

In light of this new environment, businesses will need to focus on what is happening in Washington so that they can effectively identify the opportunities and manage the risks that arise when tax laws change.

For example, in many cases of new or increased tax burdens, transition relief is appropriate but often must be sought. Monitoring the entire process as legislation moves through Congress is one of the most effective ways to spot such opportunities and to ensure that new tax law changes do not unnecessarily catch businesses by surprise.

Creating fairness

A hallmark of the Obama campaign was the President-elect's passion for restoring what he characterized as "fairness" to the tax system. This was most directly expressed in his proposals related to individual rates and to the tax treatment of international companies. At a more detailed level, Obama has advanced some specific proposals that would be seen by their advocates as improving fairness.

Codification of economic substance — Obama supports legislation to codify the economic substance doctrine and penalize noneconomic substance transactions. Such rules have previously passed the House and Senate but have not been enacted.

The most recent proposals in the Senate and House would create a two-pronged test that would be applied when a court determines that the economic substance doctrine is relevant to a transaction (or a series of transactions). It would require that (1) a transaction produce a meaningful change in a taxpayer's economic position (apart from federal tax consequences), and (2) the taxpayer has a substantial nontax purpose for entering into the transaction and the transaction is a reasonable means of accomplishing that purpose. A strict-liability penalty (of 30 or 40 percent, depending on the particular legislation) would apply to any tax understatement attributable to an undisclosed noneconomic substance transaction. (The penalty would be 20 percent if the transaction was disclosed). Two as yet unresolved issues in Congress are whether the strict-liability penalty must be reviewed and approved by the National Office of the IRS Chief Counsel before its imposition and whether payment of the penalty would have to be reported to the Securities and Exchange Commission.

Private equity — Obama supports legislation that would increase taxes on certain private equity and hedge fund entities. Specifically, he has stated that he would propose legislation to tax income from carried interests as earned income subject to ordinary rates and self-employment taxes. Such legislation was approved by the House twice in the past two years. Obama also supports legislation that would tax publicly traded partnerships engaged in investment advisory services or related asset management services as corporations.

Executive compensation — During the campaign, Obama indicated that he would examine the tax treatment of executive compensation, but offered little detail beyond closing loopholes in the "corporate tax deductibility of CEO pay." Proposals are possible in three areas. First, the leadership of the Senate Finance Committee has proposed a \$1 million limitation on nonqualified deferred compensation. Second, current law includes a \$1 million limitation on the deduction of compensation that is not tied to performance. The recently enacted Emergency Economic Stabilization Act of 2008 (EESA) included a \$500,000 limitation on compensation for certain executives without any exception for performance-based pay. (The limitation applies to certain employers participating in the government's troubled assets relief program.) This suggests that the \$1 million limitation rules of present law could be open for discussion. Third, the EESA provides for nontax governance rules with respect to executives in companies participating in the recovery plan that would prohibit certain golden parachute payments, require recovery of incentive compensation that is paid based on earnings or gains that later prove to be materially inaccurate, and limit employment contracts that provide for any payment on account of involuntary termination, bankruptcy, or insolvency. These kinds of limitations could be woven into a revision of current-law limitations.

Be aware of financial statement implications

Corporate taxpayers should be aware of how the President-elect's proposals will affect their financial statements. Pursuant to Financial Accounting Standards Board Statement No. 109, *Accounting for Income Taxes*, any adjustment to deferred tax liabilities and assets for the effect of a change in tax laws or rates is included in income from continuing operations for the period that includes the enactment date. The enactment date in the U.S. federal jurisdiction is the date the president signs a tax bill into law.

For interim reporting purposes, the tax effects of a change in tax laws or rates on taxes currently payable or refundable for a prior year are reflected in the interim period that includes the enactment date. The effects of a change in tax laws or rates on taxes currently payable or refundable for the current year are reflected in the interim period that includes the effective date of the new legislation and no earlier than the interim period that includes the enactment date of the new legislation. The effect of a change in tax laws or rates on a deferred tax liability or asset is reflected in the first interim period that includes the enactment date of the new legislation rather than allocated among interim periods remaining in the fiscal year by an adjustment of the annual effective tax rate.

Health care reform

During the campaign, Obama called for far-reaching health care reform. As part of financing his reform plan, he would require large employers that do not offer, or make a meaningful contribution to, the cost of health care for their employees to contribute a percentage of payroll toward the costs of a National Health Insurance Exchange. He has not indicated what percentage of payroll would be required under this proposal or specified what amount would constitute a "meaningful contribution" to the cost of health care. Small businesses would be exempt from this requirement and would receive a new Small Business Health Tax Credit intended to reduce their health care costs.



Individual taxes

Viewed broadly, President-elect Obama's plan for individual taxes as presented in the campaign falls into five large pieces. First, he has proposed a series of immediate steps to address the economic crisis. Second, he would adjust individual income tax rates to raise taxes on high-income individuals while preventing tax increases on the lower- and middle class. Third, he would prevent expansion of the current-law AMT. Fourth, he would enact a series of new or expanded tax credits or incentives — many of them refundable — for workers, families, and retirees. Finally, he would freeze the estate and gift tax at their 2009 rates and exemption amounts.

Most observers believe that a stimulus package, including some tax provisions, will be passed early in 2009 if not in a lame duck session prior to the end of 2008.

Beyond these measures, Obama may choose to delay action on taxes while other priorities are addressed. Such a delay, however, would be temporary. The Internal Revenue Code will require attention by 2011. The lower rates, expanded tax brackets, and increased child credit enacted in 2001 all will expire at the end of 2010. The AMT threatens, without further action, to ensnare an additional 20 million taxpayers. The estate tax, which is set to drop to zero for 2010 only, will be reinstated in 2011 at the significantly higher rates and significantly lower exemption amounts that were in effect in 2000. For taxpayers, this means that the question of whether rates on high-income individuals will go up has, for practical purposes, been replaced with the question of when they will go up.

Economic stimulus

During the campaign, Obama called for immediate action on a series of tax changes to provide additional relief in the face of ongoing economic turmoil. He would accelerate his \$500-per-worker Making Work Pay Credit to permit the IRS to mail refunds to eligible taxpayers based on 2007 returns and would expand the credit to seniors as a "down payment" on his plan to exempt seniors from tax if they have an income below \$50,000.

For individuals who have lost their jobs, Obama would extend unemployment insurance and suspend taxation of unemployment payments.

For retirement account holders, he would permit penalty-free hardship withdrawals of 15 percent from an IRA, up to \$10,000, through 2009. Obama has suggested he would ask Congress to approve the provision retroactively for 2008. In addition, he would suspend IRA and 401(k) minimum distribution requirements that now apply to account holders over age 70½.

Individual rates

Under present law, the lower rates on ordinary income, the 15 percent top rate on capital gains and qualified dividends, marriage penalty relief, and the increased child credit — all of which were enacted as part of the Bush tax cuts of 2001 and 2003 — will expire at the end of 2010.

Obama campaigned on promises to preserve these benefits for married couples earning less than \$250,000 and singles earning less than \$200,000. Conversely, he promised to raise taxes on those earning more. Thus, Obama would:

- Reinstating the top two individual income tax rates (currently 33 and 35 percent) at their pre-2001 levels of 36 and 39.6 percent while maintaining the existing 10, 15, 25, and 28 percent tax brackets;
- Increasing the capital gains rate to 20 percent for taxpayers in the top two tax brackets;
- Continuing to apply the same tax rates to qualified dividends as capital gains; and
- Reinstating for high-income taxpayers the personal exemption phase-out and itemized deduction limitation, which are scheduled to be fully phased out starting in 2010.

In effect, the Obama plan would raise the top income tax rate, considering these phase-outs, to 40.79 percent from its 2008 level of 35.35 percent.

Planning for rate changes

Although rates may not increase for 2009, the possibility of a rate hike in 2010 or 2011 is very high with the election of President-elect Obama and increased Democratic majorities in both chambers of Congress. If you have gains on capital assets or deferred compensation, you will want to consider whether to accelerate that income into low tax rate years. The rate increases that Obama has identified are in effect 5 percentage points on capital gains and 5.44 percentage points on ordinary income.

Thus, the analytical question is essentially this: How much cost are you willing to incur to save 5 percent? For example, if you held a security worth \$300,000 with a basis of \$200,000, your gain would be \$100,000. The potential tax savings from selling early would be \$5,000. If transaction costs of selling were 2 percent applied to the entire \$300,000 of value, then it would cost \$6,000 to sell the security, plus loss of the use of that \$6,000, plus \$15,000 of tax in making the next investment. Under these facts, all other things being equal, making the sale simply to save tax would not seem advisable.

In the case of deferred compensation, the analysis may produce a more appealing answer. Deferred compensation has no basis, so the potential savings apply to the entire amount and transaction costs typically are fairly low. Of course, since electing to take deferred compensation may either trigger penalty taxes or require additional financing, you should consult your professional advisor before accelerating deferred compensation.

How will you fare?

Politicians throw out big numbers — no one pays more taxes, tax cuts to 95 percent of taxpayers, billions of dollars in tax relief. But what doesn't always get discussed is how those promises translate into bottom-line tax savings — or tax increases — for individual taxpayers and families.

Consider a family of four with median income earned in 2007 of \$76,000. Assuming the family's income is all wage income from two working spouses, President-elect Obama's tax plan, if in effect for 2008, would provide a tax cut of about \$1,000, resulting from his Making Work Pay Credit. The proposed refundable tax credit would essentially return FICA taxes paid on the first \$8,100 of earnings per wage taxpayer.

A single taxpayer earning the same amount would similarly get a tax cut of about \$450.

How would wealthier taxpayers benefit under the Obama tax plan? As the President-elect has promised, he would provide tax cuts to those families earning less than \$250,000 and individuals earning less than \$200,000.

A family of four with combined income of \$500,000 from various sources (wages, interest, and long-term capital gain and dividends) could expect an increase in taxes of \$3,100 in 2008. This would result from increases in both ordinary and capital gains income tax rates and reinstatement of limitations on the use of personal exemptions and itemized deductions. Some of the family's income would be taxed in the highest tax bracket of 39.6 percent.

This family under current law would owe AMT, but that liability disappears under the Obama plan because of the increase in ordinary rates (up to 39.6 percent compared to up to 28 percent for AMT income).

A single taxpayer earning the same income would see a bigger tax bite. The increase in the Obama plan would be about \$11,500, resulting from more ordinary income taxed in both the 36 and 39.6 tax brackets, higher capital gains tax, and increases in the limitations on the use of personal exemptions and itemized deductions.

According to the IRS, taxpayers earning \$500,000 or more represented less than 1 percent of all tax filers, but they accounted for 20 percent of all adjusted gross income and 36 percent of income taxes paid during 2006.

Alternative Minimum Tax

The current version of the AMT, which was enacted in 1987, was intended to prevent approximately 140,000 economically affluent taxpayers from compounding deductions and credits in such a way as to effectively avoid paying any significant federal income tax. Because the AMT was not adjusted for inflation, more taxpayers become subject to it each year. In recent years, its reach has been limited to approximately 4 million taxpayers through annual temporary increases in the AMT exemption amount. Without the most recent patch for 2008, more than 20 million additional taxpayers would have been hit with AMT liability this year. Ironically, those threatened with this tax are generally not high-income taxpayers, but rather middle- and upper-middle-class families that have larger numbers of children or pay high state and local taxes.

President-elect Obama has proposed extending and indexing the temporary increase in the AMT exemption amount enacted for 2008. This would prevent a dramatic increase in the number of AMT taxpayers. His increases in ordinary tax rates also would remove some high-income taxpayers from AMT by increasing the amount of their

regular tax liability. Although many in Congress would, in theory, favor a full repeal of the AMT, the Obama proposal reflects the deeper reality that a full repeal would be very expensive in an era in which the size of the pie for tax relief will be limited.

New tax benefits and incentives

President-elect Obama also proposes an array of targeted tax relief measures for workers, families, and the elderly.

Workers — The most dramatic of his proposals for workers is a tax credit that, in effect, would refund to each individual below an income-based phase-out an amount equal to his or her Social Security tax payments on the first \$8,100 of wages. This Making Work Pay Credit would equal 6.2 percent of up to \$8,100 of earnings (the maximum credit would be \$502). This credit would phase out as income exceeds \$75,000 for singles (\$150,000 for couples).

Obama also would ask Congress to expand the current-law earned income tax credit to increase the available credit for single workers and families with three or more children, and would extend the phase-out of the credit for joint filers with children. He would modify the current saver's credit for lower-earning taxpayers to create a fully refundable credit equal to 50 percent of qualified retirement savings contributions up to \$500 for individuals (\$1,000 for couples).

Families — In addition to making the \$1,000 child credit permanent, Obama would offer tax assistance to families through targeted provisions such as:

- Increasing the maximum dependent care credit from 35 percent to 50 percent, making it refundable, and extending the income range over which the credit phases down;
- Replacing the current tuition tax credits with a fully refundable tax credit of up to \$4,000 for qualifying higher education expenses. Students receiving the American Opportunity Tax Credit would have to perform 100 hours of community service upon completing their education; and
- Creating a Universal Mortgage Credit for nonitemizers equal to 10 percent of mortgage interest up to a maximum credit of \$800.

One of Obama's more controversial proposals would provide an emergency energy rebate of \$500 (\$1,000 for families) to be funded by a windfall profits tax on oil companies. The urgency of this proposal may have been muted, however, by both the economic downturn, which may lead to other more direct relief for families, and by the decline in oil prices in recent weeks.

Elderly — The President-elect campaigned on a promise to exempt from tax the income of seniors over age 65 who earn less than \$50,000. The details of this proposal are not clear. The benefit of the exemption would phase out above \$50,000.

Estate tax

Obama would make permanent the basic 2009 estate tax structure, which taxes roughly 0.3 percent of estates. Specifically, he would provide an exemption of \$3.5 million per person or \$7 million per couple. As under existing law, the estate tax rates would range from 18 to 45 percent.

Who pays what?

The issue of who pays how much of the individual income tax burden was often raised by the candidates during the campaign. Sen. McCain promised to not raise taxes, while now-President-elect Obama pledged to give a tax cut to 95 percent of taxpayers. The focus of their strongest disagreement was on the taxation of high-income individuals. Their conflicting views often resulted in confusion for the electorate.

So who does pay what? According to Internal Revenue Service data for 2006 individual income tax returns, taxpayers with income over \$30,000 pay 97.5 percent of all of the U.S. individual income tax collected, while those with lower incomes owe little or no tax at all, or even receive refundable tax benefits.

Taxpayers who earned more than \$200,000 were the focus of campaign attention. In 2006, this group — about 3 percent of the nation's tax filers — paid 53 percent of income taxes. This same group earned over 30 percent of reported adjusted gross income from all sources, including about 20 percent of the nation's paid wages.

The significant percentage of total income taxes paid by upper-income taxpayers has fueled Republican calls for an across-the-board extension of the Bush tax cuts.

For their part, Democrats see a small group of taxpayers who benefit from a disproportionate share of the nation's income and, as a result, they tend to favor a stronger progressive tax system. They also consider the impact of federal payroll taxes (FICA and SECA taxes) on lower-income taxpayers. As a percentage of income, payroll taxes place a much greater burden on lower-income taxpayers. While those making under \$30,000 may owe little or no income tax, they pay about 9 percent of all payroll taxes, according to the Joint Committee on Taxation. In contrast, those earning more than \$200,000 — while paying the lion's share of individual income tax — pay only about 12.9 percent of payroll taxes.

Long-term Social Security payroll tax increase

Although the need for Social Security reform is often discussed, long-term solutions are not apparent. After 2017, Social Security expenditures are expected to exceed employer and employee payroll tax collections. Add to this the fact that by 2025, 31 percent of U.S. adults will be retirement age and it becomes clear that preservation of the Social Security trust fund surplus and future solvency of the system are at risk.

To address these long-term needs, Obama has said that he would propose an additional payroll tax to take effect 10 years or more in the future. This tax would be at a rate of between 2 and 4 percent (split between employer and employee) and would apply to income above \$250,000. We believe that action on any such proposal will necessarily be delayed until the administration and Congress are prepared to engage in a broader discussion of what to do about entitlement spending. Increasing wage taxes in the absence of decisions regarding benefit levels, overall wage tax levels, and means testing would make little political or policy sense.

If not ‘Whether?’ or ‘What?’ then ‘When?’ — possibilities for delay

After eight years of a Republican president and Congresses that were either Republican or narrowly Democratic, the Democrats are anxious to advance their agenda on many fronts in addition to taxes. They will want to address an array of domestic issues including economic recovery, the financial markets, environmental regulation, the State Children’s Health Insurance Program, health care more generally, and education.

These competing priorities will demand that the administration and congressional leadership set priorities in the context of the economy and with an eye toward the legislative process. From an economic perspective, the current downturn may lead the administration to delay a comprehensive tax program as it addresses other urgent matters. Alternatively, the administration could conclude that its vision of sound tax policy should be enacted promptly to support a long-term economic turnaround.

Regardless of how this decision is made in the coming weeks, we believe three things will be true:

- First, some tax relief will be proposed early in the new administration as part of economic recovery legislation.
- Second, later in the year as Congress and the White House confront the need to extend a variety of expiring individual and business tax provisions as well as another year of AMT relief, the ballooning deficit projections that have accompanied the current economic crisis and recovery efforts will make Obama and Democratic lawmakers much less sympathetic to pleas that these provisions be extended without offsetting tax increases.

- Third, by 2011, Obama and the Democratic Congress are very likely to have succeeded in their desire to raise ordinary income tax rates, as well as capital gains and dividend rates on the highest-income individuals.

Even with solid Democratic majorities in the Congress, moving tax legislation could be difficult. Given the swelling budget deficit, the reality is that tax increases or spending cuts will be necessary to offset at least some of the cost of tax relief. This will require lawmakers to cast votes that could prove unpopular with their constituents.

One way to simplify the process of getting tax legislation through Congress is the use of budget reconciliation. This approach allows lawmakers to combine tax and spending measures into a single bill — and to avoid having to cast a series of votes on painful fiscal issues.

Reconciliation also removes certain procedural hurdles that make shepherding controversial tax legislation through the Senate using regular order nearly impossible. It provides for expedited consideration of tax legislation in the Senate by limiting debate to 20 hours and prohibiting filibusters. Under normal order, it takes 60 votes to cut off debate and bring a bill to the Senate floor for passage. Amendments to reconciliation legislation must also be germane, which prevents senators from offering popular amendments that could weigh down and ultimately kill the underlying legislation. (These procedural hurdles are not an issue in the House, where the Rules Committee sets out the terms of debate.)

The timing of major tax legislation will be in doubt until the economic situation and the President-elect’s strategy for governing come into sharper focus. In the interim, taxpayers can take advantage of the time to engage in appropriate planning under present law and to prepare for change.



Postcards from the campaign trail: Overview of Obama's core tax proposals

Business tax incentives¹

- Make research tax credit permanent.
- Lower corporate tax rate for companies that expand or start operations in the U.S.

Business-related revenue raisers²

- Raise \$76 billion a year in largely unspecified revenue offsets.
- Eliminate oil and gas tax incentives.
- Require information reporting of securities transactions.³
- Codify the economic substance doctrine.
- Reform international tax rules, including modifying Subpart F deferral to "end incentives for companies to ship jobs overseas" and closing the "offshore pension loophole."³
- Establish an international "tax havens watch list" of countries that do not share information returns with the U.S.
- Tax publicly traded partnerships as C corps.
- Tax carried interest as ordinary income.
- Close loopholes in "corporate tax deductibility of CEO pay."

Ordinary income tax rates

- Reinstate pre-2001 top individual tax rates of 39.6 and 36 percent for families making over \$250,000 (\$200,000 for singles).
- Make permanent certain Bush tax cuts, including \$1,000 child credit, marriage penalty relief, and 10, 15, 25, and 28 percent individual tax rates.
- Restore PEP/Pease (personal exemption phase-out and itemized deduction limitation) phase-outs at an increased threshold of \$250,000 for joint filers (\$200,000 for singles). Index threshold amounts for inflation.

Capital gains and qualified dividends

- Raise capital gains and qualified dividend rates to 20 percent for families earning more than \$250,000 (\$200,000 for singles).
- Eliminate all capital gains taxes on start-ups and small businesses to encourage innovation.

New individual tax cut proposals

- Eliminate all income taxes for seniors (age 65 and over) earning under \$50,000 a year.
- Create a refundable Making Work Pay Credit equal to 6.2 percent of up to \$8,100 in earnings for those making less than \$75,000 a year (maximum \$500 credit per spouse).
- Create a refundable 10 percent Universal Mortgage Credit for nonitemizers (up to a maximum of \$800).
- Replace existing Hope credit with a refundable American Opportunity Tax Credit, providing up to \$4,000 per year for qualifying higher education expenses.
- Expand the earned income tax credit program.
- Mandate automatic employee enrollment in 401(k) plans where employers offer retirement plans. Require employers that don't offer retirement plans to provide employees with access to automatic IRAs.
- Expand Savers Credit and make it refundable. For working families earning under \$75,000, government would match \$500 of first \$1,000 saved and deposit into account.
- Increase child care dependent maximum credit rate to 50 percent and increase phase-out threshold to \$30,000.
- Provide taxpayers who take standard deduction prefiled tax forms to verify, sign, and return.

Estate and gift tax

- Increase exemption level to \$3.5 million per person (\$7 million per couple) and increase top rate to 45 percent.

Individual alternative minimum tax

- Extend and index 2007 patch.^{3, 4}

Postcards from the campaign trail: Overview of Obama's core tax proposals

Energy

- Create an emergency energy rebate of \$500 (\$1,000 for families) to be funded by a windfall profit tax on oil companies.
- Extend for five years the section 45 renewable production tax credit.³
- Impose windfall profits tax on oil and gas companies.
- Provide a \$7,000 tax credit for purchase of advanced technology vehicles.
- Provide \$4 billion in retooling tax credits and loan guarantees for domestic auto plants and parts manufacturers to produce new fuel-efficient cars.

Health care

- Provide a refundable tax credit to small businesses that provide health insurance to employees to claim up to 50 percent on premiums.

Technology reform

- Provide true broadband to every community through new tax and loan incentives.

Payroll tax

- Retain existing payroll tax on first \$102,000 of income (indexed for inflation). Exempt income from \$102,000 to \$250,000, then reinstate a 2-4 percent payroll tax (combined employee and employer) on income above \$250,000. According to Obama, proposal would not take effect for at least 10 years.

Notes

¹ A Preliminary Analysis of the 2008 Presidential Candidates' Tax Plans, The Tax Policy Center, June 20, 2008 (updated Sept. 15, 2008).

² Ibid.

³ The Emergency Economic Stabilization Act of 2008, enacted during the campaign, provided for reporting on stock basis by brokers, limited offshore deferred compensation, and extended the AMT patch for 2008. It also included a one-year extension of the section 45 credit for wind and refined coal facilities, and a two-year extension for other qualifying facilities.

⁴ Tax Policy Center, 2008.

Economic recovery: Obama's temporary tax stimulus proposals

Proposals affecting businesses

Refundable tax credit for new hires	<ul style="list-style-type: none"> • Create a New American Jobs Tax Credit, available in 2009 and 2010, for existing businesses that hire additional full-time employees in the U.S. (\$3,000 credit for each additional full-time employee).
Section 179 expensing limit	<ul style="list-style-type: none"> • Extend section 179 small business expensing limit of \$250,000 through December 31, 2009.

Proposals affecting individuals

Withdrawals from tax-preferred accounts	<ul style="list-style-type: none"> • Allow penalty-free hardship withdrawals of 15 percent (up to \$10,000) from retirement accounts in 2008 and 2009; withdrawals would be subject to normal income taxes.
Mandatory retirement account withdrawals	<ul style="list-style-type: none"> • Temporarily suspend requirement that retirees over age 70-1/2 withdraw funds from tax-preferred accounts. • Exempt from taxation withdrawals made by retirees over age 70-1/2 up to the required minimum amount.
Taxation of unemployment benefits	<ul style="list-style-type: none"> • Temporarily suspend taxes on unemployment insurance benefits.
Accelerated tax cuts for workers, families, seniors	<ul style="list-style-type: none"> • According to a summary provided by the Obama campaign, Obama would accelerate his already proposed "permanent tax cut of \$500 for workers and \$1,000 for families" by having the IRS mail out direct payments to taxpayers "based on tax returns already filed for tax year 2007." The summary also indicates that "Obama would extend these expedited tax credits to senior citizens who are retired as a down payment on his plan to eliminate taxes for all seniors making up to \$50,000."

Source: Information is based on a summary provided by the Obama campaign.

Major Democratic revenue-raising options

President-elect Obama has called for revenue raisers, many of which are largely unspecified, that could have a significant effect on business taxation. The table below shows the major revenue offsets that are either (1) proposed by the President-elect; (2) pending in active House or Senate tax legislation (that is, vetted by the House Ways and Means Committee or considered on the Senate floor); or (3) included in comprehensive tax reform legislation introduced by House Ways and Means Chairman Rangel.

These provisions represent what Obama may consider as ways to pay for his tax cut proposals.

Proposals	President-elect Obama	Active in House or Senate	Rangel Tax Reform
General business			
Reduce the dividends-received deduction			✓
Repeal the section 199 deduction			✓
Repeal the last-in, first-out (LIFO) accounting method			✓
Repeal the "lower of cost or market" inventory valuation method			✓
Increase the amortization period for intangible assets to 20 years			✓
Close loophole in corporate tax deductibility of CEO pay	✓		
International			
Deny deductions on unrepatriated controlled foreign corporation (CFC) income			✓
Deny deferral of income from CFCs	✓		
Repeal or additional delay of worldwide interest allocation election		✓	✓
Limit treaty benefits on payments by foreign multinationals incorporated in tax havens		✓	✓
End Domestic International Sales Corporation (DISC) provisions			✓
General compliance			
Codify the economic substance doctrine	✓	✓	✓
Passthrough entities			
Treat S Corp and limited partnership employees in service businesses as receiving self-employment income			✓
Tax publicly traded partnerships as corporations	✓	✓	
Tax income from carried interests as ordinary income	✓	✓	✓
Change employee stock ownership plan rules			✓
Energy			
Repeal section 199 for oil and gas companies	✓	✓	
Repeal or modify oil and gas incentives: <ul style="list-style-type: none"> • Amortization of geological and geophysical costs; • 15-year natural gas distribution lines; and • 7-year natural gas gathering lines 	✓	✓	
Oil- and gas-specific revenue raisers <ul style="list-style-type: none"> • 13-percent excise tax imposed on: oil or gas extracted from the Outer Continental Shelf in the Gulf of Mexico, finished gasoline on its removal from the refinery or entry into the U.S., and fuel removed by refineries and terminals in trade zones 	✓	✓	

Possible changes to tax rates under President-elect Obama

President-elect Obama has proposed to restore the pre-Bush tax brackets of 36 and 39.6 percent for higher-income taxpayers. The following shows how the current income tax rate table would change if Obama's proposals were in effect for 2008. (Changes are shown in red.)

Taxable income		Tax is <i>plus</i> % on excess			of the amount over
Single					
<i>from</i>	0.00	<i>to</i>	8,025.00	0.00	10.00% 0.00
<i>from</i>	8,025.00	<i>to</i>	32,550.00	802.50 <i>plus</i>	15.00% 8,025.00
<i>from</i>	32,550.00	<i>to</i>	78,850.00	4,481.25 <i>plus</i>	25.00% 32,550.00
<i>from</i>	78,850.00	<i>to</i>	164,550.00	16,056.25 <i>plus</i>	28.00% 78,850.00
<i>from</i>	164,550.00	<i>to</i>	357,700.00	40,052.25 <i>plus</i>	33.00% 36.00% 164,550.00
<i>from</i>	357,700.00			103,791.75 109,586.25 <i>plus</i>	35.00% 39.60% 357,700.00
Married filing jointly					
<i>from</i>	0.00	<i>to</i>	16,050.00	0.00	10.00% 0.00
<i>from</i>	16,050.00	<i>to</i>	65,100.00	1,605.00 <i>plus</i>	15.00% 16,050.00
<i>from</i>	65,100.00	<i>to</i>	131,450.00	8,962.50 <i>plus</i>	25.00% 65,100.00
<i>from</i>	131,450.00	<i>to</i>	200,300.00	25,550.00 <i>plus</i>	28.00% 131,450.00
<i>from</i>	200,300.00	<i>to</i>	357,700.00	44,828.00 <i>plus</i>	33.00% 36.00% 200,300.00
<i>from</i>	357,700.00			96,770.00 101,492.00 <i>plus</i>	35.00% 39.60% 357,700.00
Head of household					
<i>from</i>	0.00	<i>to</i>	11,450.00	0.00	10.00% 0.00
<i>from</i>	11,450.00	<i>to</i>	43,650.00	1,145.00	15.00% 11,450.00
<i>from</i>	43,650.00	<i>to</i>	112,650.00	5,975.00 <i>plus</i>	25.00% 43,650.00
<i>from</i>	112,650.00	<i>to</i>	182,400.00	23,225.00 <i>plus</i>	28.00% 112,650.00
<i>from</i>	182,400.00	<i>to</i>	357,700.00	42,755.00 <i>plus</i>	33.00% 36.00% 182,400.00
<i>from</i>	357,700.00			100,604.00 105,863.00 <i>plus</i>	35.00% 39.60% 357,700.00
Married filing separately					
<i>from</i>	0.00	<i>to</i>	8,025.00	0.00	10.00% 0.00
<i>from</i>	8,025.00	<i>to</i>	32,550.00	802.50 <i>plus</i>	15.00% 8,025.00
<i>from</i>	32,550.00	<i>to</i>	65,725.00	4,481.25 <i>plus</i>	25.00% 32,550.00
<i>from</i>	65,725.00	<i>to</i>	100,150.00	12,775.00 <i>plus</i>	28.00% 65,725.00
<i>from</i>	100,150.00	<i>to</i>	178,850.00	22,414.00 <i>plus</i>	33.00% 36.00% 100,150.00
<i>from</i>	178,850.00			48,385.00 50,746.00 <i>plus</i>	35.00% 39.60% 178,850.00

Prospects for expiring Bush tax cuts in the Obama administration

President-elect Obama has pledged to preserve the Bush tax cuts (which are set to expire in 2010) for married couples earning less than \$250,000 and individuals earning less than \$200,000. This table compares how the fully phased-in Bush tax cuts stack up against what we're likely to see under the Obama administration.

Provisions	Fully phased-in Bush tax cuts	Obama	
Rates	35%	Restore 39.6% bracket	
	33%	Restore 36% bracket	
	28%	28%	
	25%	25%	
	15%	15%	
	10%	10%	
Marriage penalty relief (standard deduction, 15% bracket)	Twice single-level	Twice single-level	
Child credit	\$1,000	\$1,000	
Limitations for personal exemption and itemized deductions	Repeal	36% 39.6%	Restore limitation for highest two brackets
		10% 15% 25% 28%	Repeal for lower brackets
AMT exemption	2008 Patch, \$46,200 single (\$69,950 married). Congress may continue to increase exemption amounts annually.	Extend 2008 patch and index for inflation	
Estate tax	Repeal in 2010; revert to pre-Bush tax rates and structure in 2011.	<ul style="list-style-type: none"> • Top Rate -- 45% • Exemption -- \$3.5 million (per spouse) 	

Contacts

Clint Stretch

Managing Principal, Tax Policy
Deloitte Tax LLP
+1 202 879 4935
cstretch@deloitte.com

Jeff Kummer

Director of Tax Policy
Deloitte Tax LLP
+1 202 220 2148
jkummer@deloitte.com

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The text was prepared by: Donna Edwards, Tom Louthan, and Bart Massey, Senior Managers; Jon Almeras, Michael DeHoff, Michelle Johns, Kathy Loden, and Elizabeth Magin, Managers; and Joel Deuth and Brendan Mahoney, Tax Consultants.

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