Tax Update

Tilting at Windmills? Deficit Reduction and Tax Reform in the 112th Congress

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While spending cuts have headlined the national debate on deficit reduction, tax reform has also been a key component in policymakers' plans. In this Tax Update, we offer a brief overview of the individual income tax provisions within each of the major proposals currently being considered in Washington.

The titular reference to Don Quixote's misadventures in La Mancha is often used in the context of unwinnable or futile battles. In light of the rancorous partisan reaction to several recent deficit reduction proposals, an agreement on precisely *how* to solve this problem might indeed seem an impossible dream. However, a closer look at the proposals reveals a surprisingly large swath of common ground in the area of tax reform. Stark differences exist as well, of course, but consider the following excerpt from a high-profile reform proposal:

> "The code is also patently unfair, as many of the deductions and preferences in the system — which serve to narrow the tax base — are mainly used by a relatively small class of mostly higher-income individuals."

One might reasonably guess this passage was lifted from the "Moment of Truth" report from the President's Commission on Fiscal Responsibility and Reform or a recent speech by President Obama himself. It is, in fact, a direct quote from House Budget Chairman Paul Ryan's "Roadmap for America's Future." The tax reform provisions in competing deficit reduction proposals share some interesting common elements, especially in the treatment of "tax expenditures" — Beltway terminology for tax revenue effectively lost due to deductions, exclusions, credits, deferrals, and preferential rates in the tax code (see Tax Expenditures on page 2).

Each of the main deficit reduction and tax reform proposals offered in recent months addresses tax expenditures in a meaningful way.

A brief overview of each proposal is set forth below.

Deficit Reduction/Tax Reform Proposals

National Commission on Fiscal Responsibility and Reform — ("Simpson/Bowles")

In this "Moment of Truth" proposal, a majority of the committee's 18 Democrats and Republicans agreed that everything from spending to tax rates to popular itemized deductions must be on the table. The "Zero Plan" developed by this group may be an important first step in achieving meaningful tax code reform. The plan offers very low tax rates in exchange for eliminating all tax expenditures. Any tax expenditures added back into the tax code would have to be paid for with incrementally higher tax rates. A national debate along these lines would be most intriguing, and the lobbying effort would likely be spectacular. Industry groups, charitable organizations, and anyone else with a vested interest in preferential tax code treatment would want their voices to be heard. An alternate approach, which includes limited tax credits for certain popular tax expenditures, was offered in the report. This is referred to in Exhibit 1 as the "Simpson/Bowles 'Illustrative Plan.'"

Bipartisan Policy Center Debt Reduction Taskforce — ("Domenici/Rivlin")

The Bipartisan Policy Center's "Restoring America's Future" proposal calls for creating a simple, pro-growth tax system that would broaden the tax base, reduce rates, and raise revenue to lower the national

Tax Expenditures

Although beneficial tax code provisions may not feel like actual expenditures, the net economic effect of a $100 reduction in tax receipts as the result of a tax deduction is exactly the same as an actual government outlay of $100. Indeed, tax expenditures are often referred to as "tax code spending" or "tax earmarks" since they generally benefit one group of taxpayers at a cost that is borne by everyone else in the form of higher tax rates. The amount of foregone revenue due to tax expenditures was more than $1 trillion in 2010. *This is more than the total amount of revenue raised through individual income taxes alone.*

The following table reflects the largest tax expenditures in 2010:

Tax Expenditure Item	Estimated Foregone 2010 Tax Revenue
Exclusion of employer-provided health insurance from taxable income	$262 billion
Tax treatment of qualified retirement plans (pensions, IRAs, 401(k) plans, etc.)	$122 billion
Deduction for mortgage interest	$92 billion
Deduction for state and local taxes	$53 billion
Reduced tax rate on capital gains	$45 billion

debt. Similar to the Simpson/Bowles Illustrative Plan, this approach would eliminate many tax expenditures but would include limited tax credits for mortgage interest and charitable contributions. Notably, this plan includes a 6.5% national sales tax dedicated to reducing the debt.

Representative Ryan's Roadmap for America's Future ("Ryan Roadmap")

Ryan's budget plan envisions a broader tax base with the elimination of nearly all existing tax expenditures to allow for a top tax rate of 25%. This plan is vastly different from other proposals in its treatment of investment income. Dividends and capital gains would *not* be subject to income tax under the Ryan Roadmap. This plan was passed by the House in mid-April but was recently voted down in the Democratic-controlled Senate.

President's April 2011 Budget Framework ("President's Framework")

The President announced his revised budget plan in a speech given a few days after the Ryan Roadmap legislation was announced. In this speech, he made it clear that he would not consider any further extension of the Bush-era tax cuts for higher-income taxpayers. Additionally, he called for reducing tax expenditures by limiting itemized deductions for the wealthiest 2% of Americans. With the onset of the 3.8% Medicare tax on investment income in 2013, higher-income taxpayers would face a significant tax increase in 2013 under the President's Framework. This approach differs starkly from the Ryan Roadmap.

Bipartisan Tax Fairness and Simplification Act of 2011 ("Wyden/Coats")

Although not technically a deficit reduction plan, Wyden/Coats is noteworthy as a bipartisan revenue-neutral legislative proposal. Originally known as Wyden/Gregg, it was co-sponsored by Senator Dan Coats following Judd Gregg's Senate retirement. This plan eliminates some tax expenditures but maintains most of the popular and more costly itemized deductions, resulting in a top tax rate of 35%.

Bipartisan Senate Effort ("Gang of Six")

A committee of six Senators, comprising three Republicans and three Democrats, has been meeting for several months in an effort to craft a bipartisan approach to reduce the deficit and reform the tax code. Many view this effort as one of the best hopes for compromise, and news of their discussions is highly anticipated. The Republican Senators include Mike Crapo and Tom Coburn, who were both members of the Simpson/Bowles commission and voted for the plan. If consensus can be reached, it seems likely their proposal will incorporate much of Simpson/Bowles. The group also includes Dick Durbin (D — Illinois), Kent Conrad (D — North Dakota), Mark Warner (D — Virginia), and Saxby Chambliss (R — Georgia).

However, with the recent announcement that Senator Coburn has taken a sabbatical from the group, prospects for near-term deficit reduction and tax reform have certainly diminished. The remaining members will continue to meet and remain hopeful they can reach a consensus.

Biden Bipartisan "Gang of Seven" ("Biden Committee")
The Biden Committee is focused on reaching a bipartisan agreement on spending reductions in connection with an increase in the federal debt ceiling. At this point, however, income tax changes do not appear to be a consideration in this effort.

Exhibit 1 below illustrates how the various plans compare in several key areas.

Common Ground v. Battleground Issues

As noted, all of the proposals have much in common. Most include a significant reduction in the tax rates and all endorse a significant reduction of tax expenditures. It seems likely these components would be present in a successful legislative effort.

Three of the proposals enjoy some level of bipartisan support — Simpson/Bowles, Domenici/Rivlin, and Wyden/Coats. Any recommendation from the Gang of Six would be bipartisan as well. In a harshly divided Congress, this would seem to be an advantage. Conversely, the Ryan Roadmap and the President's Framework have strict party-line support and would likely face an uphill climb in the current political climate.

Exhibit 1: Comparison of Tax Reform Proposals

	Ordinary Income Tax Rates	Tax Expenditures	Tax Rate On		National Sales Tax	AMT Repeal
			Dividends	Long-Term Gains		
Simpson/Bowles "Zero Plan"	8% 14% 23%	Eliminate all	23%	23%	NO	YES
Simpson/Bowles "Illustrative Plan"	12% 22% 28%	Eliminate all and add new 12% credit for mortgage interest and charitable contributions	28%	28%	NO	YES
Domenici/Rivlin	15% 27%	Eliminate most and add new 15% credit for mortgage interest and charitable contributions	27%	27%	YES	YES
Ryan's Roadmap	10% 25%	Eliminate most	0%	0%	NO	YES
President's Framework	from 10% to 39.6%	Limit them for higher-income taxpayers	43.4%	23.8%	NO	NO
Wyden/Coats	15% 25% 35%	Eliminate many but retain most popular itemized deductions	Exclude 35% from tax	Exclude 35% from tax	NO	YES
Gang of Six	TBD	TBD	TBD	TBD	TBD	TBD

Two interesting provisions are isolated to single proposals: the introduction of a national sales tax in Domenici/Rivlin and the complete exclusion of dividends and capital gains from taxable income in the Ryan Roadmap. The President's Framework also takes a divergent approach in its limiting of tax expenditure reductions to higher-income taxpayers.

The key battleground issue may be the tax treatment of investment income. Simpson/Bowles and Domenici/Rivlin remove the preferential tax treatment of dividends and capital gains, taxing these items at the same rate as ordinary income. At one end of the spectrum, the Ryan Roadmap applies a 0% rate to these income items. At the other end, the President's Framework calls for a tax rate of 43.4% on dividend income. The two sides could not be further apart. Compromise on this front will be difficult to achieve.

Uncertain Potential Outcome

As each day passes with no word of consensus from the Gang of Six, the prospect for meaningful deficit reduction and tax reform becomes increasingly grim. If the partisan positions outlined by a host of Democratic and Republican Senators and Congressmen at a recent Washington conference are any indication, the likelihood of an agreement before the summer recess is not strong. With a presidential election just around the corner, deficit reduction and tax reform may become defining issues for voters. These pressing concerns could easily be "kicked down the road" to 2013 as the first order of business for the 113th Congress.

If Congress is somehow able to reach an agreement this year, chances are good it will incorporate the broader-base and lower-rate approach taken in most of the proposals discussed above. Moreover, if we see the elimination of tax expenditures in exchange for lower tax rates, this would create winners and losers. As Cervantes observed when he wrote, "other men's pains are easily borne," this will likely be a much easier sell to the winners.

In recent years, we have clearly seen that attempting to predict tax legislation is not a task for the faint of heart. And while the quest for consensus on tax reform may indeed be quixotic, let's hope Congress will remember that "faint heart ne'er won fair lady." We will continue to monitor the situation in Washington closely and look forward to updating you as appropriate.

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