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A Practice Focus
Tax

Change on the Horizon

Congress has temporary patches and core reform on its agenda.

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Congress is rapidly approaching the busiest period of the year for legislative activity, the months from late spring until early fall. In a presidential election year, rest assured that electoral dynamics will heavily influence the legislative process.

Nowhere is this true more than in tax policy. Despite the inevitable political posturing, taxpayers can expect that Congress will address several tax issues before members return to their districts for the final campaign rush. In particular, Congress is likely to extend provisions that grant relief from the expanding reach of the alternative minimum tax as well as certain expiring tax provisions.

Beyond 2008, the tax-writing committees are already preparing for a protracted debate over fundamental reform, a debate that may address significant changes to the corporate tax system.

THE AMT STORY

Unlike the regular income tax, the structural components of the AMT, such as the exemption amounts, are not indexed for inflation. As nominal incomes and expenses grow over time, AMT liabilities increase. In 1997, about 605,000 taxpayers were subject to the AMT. By 2006, the number had increased to 3.5 million. The Joint Committee on Taxation estimates that the number will rise to more than 30 million by 2010.

In December 2007, Congress enacted a one-year "patch" that increased the AMT exemption amount to prevent millions of taxpayers from owing the AMT for the 2007 tax year. Similarly, Congress will likely take some action this year to ensure that millions of taxpayers are relieved, at least temporarily, from the AMT. President George W. Bush's budget would extend and slightly expand the AMT patch for tax year 2008 at a cost of nearly $60 billion. An outright repeal of the AMT would cost roughly $870 billion over 10 years.

Unsurprisingly, repeal or fundamental reform of the AMT, which would necessarily involve a heavy financial and political price, is an unattractive option in an election year.

NO PAY AS WE GO

Both parties in the House and Senate appear committed to extending AMT relief for the current tax year, but they disagree on whether the cost should be covered by offsetting "revenue raisers."

The House budget resolution would require that AMT relief be fully offset, thereby complying with the House's pay-as-you-go budgetary rules. House Republicans often oppose raising taxes permanently to pay for temporary AMT relief, whereas many House Democrats favor a complete offset.

In the Senate (despite its own "paygo" rules), the Senate budget resolution assumes that Congress will pass a one-year patch without revenue offsets. In the Senate, where 60 votes are necessary to avoid a filibuster, the Senate position reflects the political reality that paygo advocates lack sufficient support to push through a fully offset AMT package.

Most commentators anticipate that the House will eventually give up its demand that Congress fully offset the cost of a one-year AMT patch. A similar debate occurred in 2007, and the House accepted a one-year AMT patch without revenue offsets then. With both the House and Senate closely divided, neither Democratic nor Republican leaders want to insist on unpopular tax increases this close to a major election.

TEMPORARY SOLUTIONS

In addition to AMT relief, Congress is likely to extend certain expiring tax provisions. In recent years, for budgetary and political reasons, the number of such temporary tax provisions has exploded. Forty-one separate provisions expired on Dec. 31, 2007, and another 21 provisions are scheduled to die on Dec. 31, 2008.

On one hand, temporary provisions are attractive to Congress because they let lawmakers provide taxpayers with immediate relief without the political pain associated with provisions that contribute to long-term budgetary deficits. That is, for budget purposes, temporary provisions appear less costly than permanent provisions despite the fact that Congress is likely to extend these provisions rather than allow them to lapse.

On the other hand, at least in theory, the temporary nature of these provisions forces lawmakers to periodically reassess the provisions to ensure that they remain effective and affordable.

The Big Picture

In addition to the short-term tax legislative agenda, the tax-writing committees are already signaling that they anticipate fundamental tax reform will be at the top of their agenda in 2009.

Congress and the next president will confront enormous fiscal policy challenges. Long-term shortfalls loom for Social Security and Medicare. At the same time, globalization is putting an enormous strain on American companies, and lawmakers will be under pressure to reduce the cost of doing business in the United States to keep U.S. companies competitive with producers in China, India, and elsewhere.

The combination of these forces—the demand for tax revenue to fully finance retirement programs and the call from the business community to streamline our tax system to stay competitive—should guarantee corporate tax reform a position on the center stage.

Ultimately, the tax reform debate will be shaped by the November election. So far, the presidential candidates have primarily emphasized individual tax issues such as marginal tax rates, higher education incentives, and health-care provisions. Corporate tax policy remains a campaign backwater seldom raised in the debates and seldom directly addressed by the candidates.

Politicians on both sides of the aisle, however, are slowly realizing that corporate tax reform is worthy of their attention. Secretary Henry Paulson and the Treasury Department have tried to raise awareness of business tax competitiveness issues through high-level conferences and comprehensive studies.

In October, Rep. Charles Rangel (D-N.Y.), chairman of the House Ways and Means Committee, introduced legislation to reduce the corporate tax rate from 35 percent to 30.5 percent. At the same time, Rangel's bill would repeal several current measures that can reduce corporate taxes. For example, his bill would repeal the Section 199 domestic production deduction, change the taxation of so-called "carried interests," and repeal the last-in, first-out (LIFO) accounting method.

Although it is unlikely that Rangel's bill will in the short term be enacted, the proposals in the bill provide useful starting points for a discussion of corporate tax reform.

Time to Simplify

Fundamentally, effective corporate tax reform would likely involve streamlining and simplifying the corporate tax code.

Public finance economists, business leaders, and tax practitioners have identified numerous problems with our system for taxing corporate earnings.

A recent survey by our firm confirmed that many business leaders would give up various corporate deductions and credits in exchange for a lower corporate tax rate.

Respondents were asked to share their thoughts on legislative tax issues. One said, "We need a lower rate and less complexity. Section 199 and many other provisions are way too complex." Another person said that repealing the tax credit for research and development, Section 199, and LIFO—along with reducing corporate tax rates—"would be a great step to make the U.S. more globally competitive."

When asked whether the current tax structure for business income is in need of comprehensive reform, respondents answered almost 2-to-1 that comprehensive reform is needed. The sentiment was bipartisan, as a majority of both Republicans and Democrats expressed the view that the current system requires a fundamental overhaul.

The truth is that the statutory corporate tax rate, 35 percent, bears little relation to the tax rate actually paid by corporations. Various corporate tax preferences lower the actual or effective tax rate for some industries and professions. Other provisions raise the effective rate above the statutory rate.

Removing many of these deductions, exclusions, and credits currently found in the tax code could allow Congress to reduce the statutory corporate tax rate without losing revenue, thus complying with congressional paygo rules.

The change would inevitably create winners and losers, with some corporations paying more and others paying less corporate income taxes. Overall, however, it would likely benefit the overall economy by simplifying business decisions and reducing the costs of tax compliance.

In an election year, discussion of reforms to the corporate tax structure may not attract as much attention as the AMT. But these reforms remain important and necessary—something that a Congress of the future is likely to recognize.

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