



Administration's 2012 Tax Proposals

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In his State of the Union address, President Obama spoke to his goals of strengthening and protecting the middle class and outlined several tax proposals aimed at achieving that objective.¹ These proposals were also released with the President's budget and further details can be found in the Treasury Department's "Greenbook."² Democratic Congressional leaders have promised to bring many of these proposals up for debate and votes throughout the year, so to help keep you and your clients informed, we have provided an outline of the major proposals followed by a discussion of their political outlook. While not intended to be exhaustive, we have tried to focus on proposals that are likely to affect you or your clients. FPA will also provide updates to this article as more information becomes available.

The "Buffett Rule"

Probably the most discussed proposal is the 30% minimum effective rate on incomes over \$1 million, a.k.a. the "Buffett Rule." In general, one's effective tax rate is determined by dividing taxes owed (from line 60 of the current 1040 tax return) by adjusted gross income (from line 37). The President's budget makes clear that this rule would replace the current Alternative Minimum Tax (AMT) and would be structured to exclude charitable donations. However, the exact mechanics have yet to be released by the Administration.

Retaining current rates for those making less than \$250,000

The rate reductions passed in 2001 and 2003 are scheduled to expire at the end of this year. The President reiterated his position that those cuts should be extended for Married taxpayers Filing Jointly (MFJ) with Adjusted Gross Incomes (AGI) of \$250,000 or less (\$200,000 for singles). The current 33 and 35% brackets would revert to 36 and 39.6%, respectively. The 36% bracket would begin at a level of taxable income that corresponds to the \$250,000 (MFJ)/\$200,000 (single) threshold minus the appropriate standard deduction and personal exemptions.

For these upper-income taxpayers, dividends would be taxed as ordinary income, which is a departure from previous budget proposals by this Administration. Capital gains for these taxpayers would be taxed at 20%, instead of the current 15% rate.

Capping Deductions and Credits for High Earners

The President's budget had two proposals to limit deductions and credits that can be taken by taxpayers with AGIs over \$250,000 (MFJ)/\$200,000 (single).

Limit the value of deductions or exclusions to 28%, i.e., \$100 of deductions for a taxpayer in the 39.6% bracket would only be worth \$28, instead of \$39.60. The proposal specifically proposes to limit: employee contributions to a 401(k) or other qualified retirement plans; tax-exempt state and local bond interest; employer-sponsored health insurance paid for by employers; health insurance costs of self-employed individuals; contributions to health savings accounts and Archer MSAs; and deductions for domestic production activities (sec. 199).

Reinstate limitation on itemized deductions. Itemized deductions (other than medical, investment interest, theft and casualty losses, and gambling losses) would be reduced by 3% of the amount by which the

¹ Transcript and fact sheet for the State of the Union: <http://www.whitehouse.gov/the-press-office/2012/01/24/remarks-president-state-union-address> and <http://www.whitehouse.gov/the-press-office/2012/01/25/fact-sheet-president-obama-s-blueprint-support-us-manufacturing-jobs-dis>

² http://www.treasury.gov/resource-center/tax-policy/Pages/general_explanation.aspx

taxpayer's AGI exceeds \$250,000 (MFJ)/\$200,000 (single), up to a ceiling of 80% of the otherwise allowable deduction. This limitation was temporarily phased out by the 2001 tax cuts.

Eliminating Subsidies for Millionaires

During his State of the Union speech, the President picked up a theme espoused by Senator Tom Coburn (R-Okla.), to eliminate subsidies for taxpayers with AGIs over \$1 million. For instance, there is no income limits on who may receive supplemental nutrition (formerly Food Stamps), unemployment benefits or farm subsidies. House Republicans passed a bill in December 2011 with a provision that would have capped food stamps and unemployment benefits, but it has not yet become law.

Retirement

As noted above, the deduction for contributions to 401(k) and other defined contribution plans would be capped at 28% for taxpayers with AGI over \$250,000 (MFJ)/\$200,000 (single).

Auto IRA. As in his previous budgets, the President proposes that all employers not offering a qualified retirement plan be required to offer an automatic IRA option to employees, under which regular contributions would be made on a payroll-deduction basis. Employees would be automatically enrolled in this program but could opt out. This has been backed by groups on opposite sides of the political spectrum: the Heritage Foundation and the Brookings Institution.

Eliminate RMDs for balances of \$75,000 or less. If the aggregate of an individual's IRA and tax-favored retirement plan accumulations is \$75,000 or less, the individual would no longer be required to take a required minimum distribution (RMD). The balance amount is an increase from previous budgets that were set at \$60,000.

Education Incentives

The President called on Congress to extend the American opportunity credit, which provides up to \$2,500 a year for each eligible student for the first 4 years of undergraduate education. The credit expires at the end of this year. He also called on colleges and universities to control tuition increases or risk losing federal funding.

AMT & Tax Extenders

Notably absent from the President's budget or State of the Union was a discussion the higher exemption from the Alternative Minimum Tax (AMT patch) and a number of perennially-renewed provisions that expired in 2011, such as the tax-free rollover of required distributions from IRA to charity, the deduction for state and local sales taxes, residential energy credit, expanded small-business expensing (sec 179), and 100% bonus depreciation.³ Their omission likely reflects the political reality that these provisions will not be addressed until after the November 2012 elections.

Business Taxes

The President's budget and State of the Union also included a number of business tax changes. These include permanently extending the credit for research and development; creating an international minimum tax for multinational businesses; encouraging employers to move jobs overseas back to the U.S.; and providing more tax benefits to manufacturers. Putting their merits aside, these proposals run counter to previous tax reform discussions that center on removing credits and deductions to achieve a lower tax rate.

Outlook: Plenty of Smoke; No Fire

It's notoriously difficult to pass legislation in an election year and -- with the exception of the payroll tax cut and possibly bonus depreciation -- political strategists do not expect these proposals to be signed into law.

³ The entire list of expired and expiring provisions can be found at <http://www.ict.gov/publications.html?func=select&id=10>

The procedural issues are the biggest obstacles. The U.S. Constitution requires that all tax laws originate in the House of Representatives. So, while the Democrat-controlled Senate is expected to hold a series of votes on these proposals, the Republican-led House is unlikely to entertain further discussions. Also, the rules of the Senate generally require 60 “yes” votes to move legislation. Democrats account for only 53 possible votes, which means many issues are unlikely to advance further in the legislative process.

Despite these hurdles, these issues will provide a political opportunity for the two parties to each define themselves and their opponents to their best advantage. Democrats will note that they are promoting economic fairness and guarding the middle class while Republicans will emphasize the need for lower taxes and a smaller government to promote economic growth. Both will no doubt blame the other of financial profligacy.

The whole process promises plenty of political theatre. However, this is not to suggest that you or your clients should not closely monitor the discussions or weigh in with lawmakers. Heated exchanges are likely this year, but they will largely set the parameters of debate for 2013, when Congress (hopefully) focuses on the much larger issue of reforming the entire tax code.

If you have questions, comments, or suggested additions, please feel free to contact:

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