Tax Views

A Mixed Review For Obama Tax Proposals

Dean Zerbe

For small business, there's good, bad and ugly in new administration's budget proposal.

WASHINGTON, D.C.--Thank God for Clint Eastwood. He's provided us with so many great movies and, now, a fitting way to sort out the impact on business of President Barack Obama's new tax proposals.

The Good

Estate tax. The administration proposed making permanent this year's estate tax law, which exempts $3.5 million of each estate from tax. This may not be what some small-business owners wished for. After all, under President Bush's tax cuts the estate tax was supposedly going to disappear next year--for one year. But it could have been worse; in 2011, under current law, the estate tax exemption would have reverted to $1 million. Moreover, having certainty is of great importance for family planning and peace of mind.

R&D credit. Again, the administration deserves kudos for proposing to make the research and development credit, which is perennially expiring, permanent. A permanent credit will be a significant help for business planning. However, it will disappoint small-business owners that the administration didn't propose expanding the credit's usefulness to them by repealing the limitation imposed by the individual alternative minimum tax (AMT). Many small and medium businesses operate as S corporations or partnerships and pass through all their profits and their credits to their owners' individual tax returns. Such a change in the AMT would have allowed them to take advantage of the credit.

Small-business capital gains. The administration's proposal to eliminate capital gains for new investments in small businesses would have been higher on my "good" list if it kicked in immediately. Unfortunately, this new break only kicks in in 2014. That's particularly disappointing since now is the time when we desperately need to be encouraging new investments.

Net operating-loss carrybacks. Another worthy proposal would allow money-losing small businesses to carry back their net operating losses (NOLs) to five years (from previous law – two years). This proposal was dropped from the $787 billion stimulus at the last moment. Many members of Congress (and folks in the administration) realized they weakened the economic impact of the stimulus by dropping this provision, so perhaps this time it will stick. What's important here is it will allow struggling, once profitable businesses to get a refund of taxes they've previously paid when they most need the cash.

Individual AMT. Again, I give credit to administration for proposing to make permanent a fix that will keep millions of taxpayers from being thrown into the AMT. Note that under the administration's proposal, the AMT exemption will be adjusted each year for inflation---not adjusted to keep any more people from paying AMT, as it has been. This distinction means the number of AMT payers will continue to grow, but slowly. Still, the administration deserves credit for not kicking the can down the road.

Of course, all these good proposals are just that--proposals. I remain concerned about the administration's commitment to seeing them through Congress, given what happened to the Obama administration's business tax-cut ideas in the stimulus bill. However, in fairness, the administration was hamstrung by a number of factors including the fact that very little of its team at the Treasury was in place. Here is hoping that the good parts of the budget proposal survive longer than the Administration's proposed $3,000 hiring credit did.

The Bad

In attempting to separate the bad from the ugly, I consider those tax increases that were expected as merely bad. Those tax increases that are a surprise, I'd call ugly.

Higher income tax rates. The administration proposed allowing the Bush tax cuts for the top two brackets to expire at the end of 2010, just as I--and many others--had predicted it would. That means the top two rates on ordinary income go back up in 2011 to 36% and 39.6%, from 33% and 35% now. (One particular is a little ugly however: the mother of all marriage penalties. The higher rates kick in at $200,000 for a single individual and $250,000 for a married couple filing jointly.)

I understand there was talk at one time in the Clinton Treasury of having a lower rate for income from a small or medium business. Perhaps that idea will or should be revisited, since these high rates will be very hard on those small and medium businesses that operate as pass-throughs. Meanwhile, the administration proposes taking the top capital gains rate back up to 20% from its current 15%.

Repeal of "last in, first out" tax accounting. While expected, this effort to get at big oil will, unfortunately, pound on a number of small businesses, particularly auto dealerships, who are already taking quite a hit. It may be possible that Congress will limit this repeal to publicly traded companies--if they get an earful from their constituents. Note: LIFO hits big oil hard, but there are several smaller tax proposals in the budget that repeal specific tax breaks for oil drilling and production.

Tax carried interest as ordinary income. This attack on the managers of private-equity and hedge funds was expected. But the bill will affect more than just hedge fund managers, hitting managers of real estate as well as other partnerships. It is surprising that, given all the political zeal on this matter, the effective date doesn't appear to be until 2011.

The Ugly

The 28% limit on itemized deductions. This limit, which would affect couples earning more than $250,000, is a surprise. What's proposed is a complicated provision with a very bad impact. Imagine you are paying tax at a 35% or 39.6% rate. Look at your Schedule A and imagine that every deduction is only allowed against a 28% rate. So if you have a charitable deduction of $1000 instead of deducting it against your full 39.6% rate, you can only deduct it against 28%. You will give away the $1000 but still owe tax on it at an 11.6%. The same thing will happen with the home mortgage interest deductions.

This, in effect, pushes the top marginal income tax rate above 40%. I am already hearing from real estate folks how this will harm an already weak market and from charities that this is going to devastate donations. The numbers tell it all: This is a $179 billion dollar hidden revenue raiser. It is one of those ideas that sound good in the Harvard faculty lounge but are without a lick of common sense. My discussions on the Hill suggest that Congress is already reaching for pitchforks and torches to kill this poorly considered hidden tax.

More IRS Audits. The administration intends to pursue the tax gap with fervor. The budget proposes a significant increase in IRS enforcement over the next several years. This is despite the fact that the IRS is doing a terrible job of targeting current enforcement efforts aimed at small and medium business. The IRS is now spending its resources auditing many businesses that are 90% compliant, trying to make them 95% compliant, instead of going after the bad actors. (This is a strategic, if questionable approach; going after the hard cases, such as those who don't file returns at all, is much more labor intensive)

Included in the budget is a new reporting requirement for rental income (perhaps a hidden stimulus for the work of accountants) as well as a very worrisome "asterisk" revenue raiser. The administration attributes $210 billion in revenue raisers to "international enforcement, reform deferral and other tax reform policies." There are no specifics provided, thus the asterisk. We can guess at some of the changes, based on proposals by House Democrats. The asterisk is basically a stand-in for another $210 billion in tax increases on business.

What will happen now? As Mr. Eastwood said: "If you want a guarantee, buy a toaster." I can't guarantee anything, but I think Congress is going to have a lot to say about many of these proposals, especially the proposal to limit itemized deductions. So Congress could do some good here, but it might also let some of the better proposals by the administration fall by the wayside as it scrambles for dollars.

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