Global Sage White Paper Series

The Tax Agenda in Washington, D.C:

Current Developments

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THE TAX AGENDA IN WASHINGTON, D.C.: CURRENT DEVELOPMENTS

EXECUTIVE SUMMARY

With the mid-term elections rapidly approaching with its election year politics, and with time running out in this year's Congressional session, Congress is struggling with great difficulty to address a number of major tax issues which need resolution in 2010. If action on these taxes does not occur by year end, there will be significant increases in taxes for both individuals and businesses in 2011. Specifically:

Tax Proposals	**Outlook**
Extension of 2001/2003 "Bush" Tax Cuts	Failure to act will result in sharply higher income tax rates, capital gains and dividend rates for both individuals and businesses. A temporary extension after election probable.
Small Business Tax Cuts	Senate and House have passed $12 billion in tax relief.
Carried Interest and EVT	A tax increase on carried interest has already passed the House and is pending in the Senate, including an enterprise value tax (EVT). Strong probability these will pass as a "revenue raiser" to pay for the "Expiring Tax Provisions" bill.
Other Obama Tax Proposals	Proposals to extend R & D tax credit and allow for full expensing aimed at helping economic recovery. Passage unlikely this year.
Alternative Minimum Tax	Proposal pending to "patch" AMT to avoid major tax increase. Failure to act this year will affect 22 million taxpayers. Likely to pass after mid-term elections.
Expiring Tax Provisions	A long list of popular individual and business tax provisions that will expire at year end need to be extended. Passage in lame duck session likely.
Estate Taxes	Estate tax rates will return to pre-2001 levels in 2011 if no action taken. There is a proposal pending to set estate tax at 2009 levels. Likely to pass as a temporary measure this year.
International Tax Provisions	The House is set to pass a bill increasing taxes on corporate overseas earnings. Senate action, however, is unlikely this year.

THE TAX AGENDA IN WASHINGTON: CURRENT DEVELOPMENTS

With the mid-term elections approaching and time running out in this year's Congressional session, Congress is struggling to address a number of major tax issues which need to be resolved in 2010. Failure to act will result in higher taxes for both individuals as well as business in 2011 and beyond.

For example, the most discussed and visible number one item on the Congressional tax agenda is the pending expiration of the 2001 and 2003 "Bush" tax cuts. Unless Congress acts before the end of the year, tax rates will increase sharply on income, capital gains, dividends, and estates on January 1 2011.

However, this is but one of a number of major tax initiatives under consideration that would, if enacted (or not enacted), fundamentally reshape the tax landscape in America. Key tax issues currently under consideration in the Congress facing individual and business taxpayer's specifically include:

1. Expiration of the 2001 and 2003 "Bush" tax cuts
2. Small business tax cuts
3. Tax on Carried Interest and the Enterprise Value Tax (EVT)
4. Other Obama proposed tax changes
5. "Patching" the Alternative Minimum Tax
6. Extending various expiring tax provisions
7. Estate taxes
8. International tax provisions

Congress is scheduled to leave Washington in early October to campaign for the midterm elections. If these key tax issues are not resolved by then, Congress will have to address them in the lame-duck session after the election, ***where the prospects for resolving any issue are not high***. If not addressed, tax rates will go up in 2011 significantly.

1. EXPIRATION OF 2001 AND 2003 "BUSH" TAX CUTS

The "Bush tax cuts" enacted in 2001 and 2003 are scheduled to expire at the end of 2010. If no action is taken prior to the end of this year, tax rates for all individuals will increase, capital gains and dividend tax rates will increase, and a number of other tax credits and deductions will expire.

The President has proposed permanently extending the tax cuts for single taxpayers with income under $200,000 and married couples with income under $250,000. Under his proposal, the top individual tax rate would increase to 39.6% and capital gains and dividend tax rates would increase to 20 percent.

As alternatives to the President's proposal, Republicans and some Democrats have proposed permanently extending all the tax cuts to avoid raising taxes in a weak economy. Some Members of Congress are suggesting a one or two year extension of the top rates.

Failure to reach agreement on extending the tax cuts will result in sharp tax rate increases on individual taxpayers and capital gains and dividends in 2011, and even higher tax rates in 2013, when a new tax on "unearned income" enacted in the health care reform bill goes into effect.

PROJECTED US TAX RATES

	2010	***2011***	***2013***	***% Increase***
Ordinary Income	***35***	***39.6***	***40.5(1)***	***16%***
Interest Income	***35***	***39.6***	***43.4(2)***	***24%***
Capital Gains	***15***	***20***	***23.8(2)***	***59%***
Dividends	***15***	***39.6***	***43.4(2)***	***189%***

1-Scheduled Medicare tax increase
2-Scheduled new 3.8% Unearned Income Medicare Contributions

Prospects:

Final agreement on the tax cuts is not likely prior to the midterm elections (seemingly confirmed recently by Harry Reid). Moreover, Democrats do not have the 60 votes needed in the Senate to extend the tax cuts in the President's proposal for only those with income less than $250,000, and Republicans do not currently have the votes to extend the tax cuts for all taxpayers.

A possible compromise which permanently extends the tax cuts for those under $250,000 and temporarily (1-2 years) extends the tax cuts for those over $250,000 could be enacted in a "lame-duck" session after the November elections but before year end. We believe that there is a high probability that "some" bill will be passed.

2. SMALL BUSINESS TAX CUTS

The House and Senate have passed a small business bill which establishes a $30 billion lending facility and provides $12 billion in small business tax relief. The associated tax provisions in the bill would:

- Provide a 100% capital gains exclusion for investments in qualified small business stock
- Extend bonus depreciation for new equipment
- Increase Section 179 expensing to $500,000
- Increase the expensing limit for business start-up expenses

3. TAX ON CARRIED INTEREST AND THE ENTERPRISE VALUE TAX (EVT)

Congress is continuing its efforts to pass legislation to raise the tax on carried interest and establish an Enterprise Value Tax. Senate Finance Committee Chairman Max Baucus has reintroduced his tax extenders bill and the bill includes the carried interest tax increase. Under this proposal, 75 percent of carried interest would be taxed as ordinary income, beginning in 2011. For assets held at least 5 years, 50 percent of carried interest would be taxed as ordinary income. The Baucus proposal also includes his Enterprise Value Tax (EVT), which would tax a portion of the gain on the sale of a partnership interest as ordinary income.

Prospects:

The Baucus carried interest tax proposal is being proposed as a revenue raiser (raising $13.5 billion) to help pay for the bill to extend a number of popular expiring tax provisions. Similar legislation has already passed the House, and the Senate is under intense pressure to pass the tax extenders bill this year. As a result, there is a good chance this legislation will eventually be enacted this year.

4. OTHER PROPOSED OBAMA TAX CHANGES

The President has also proposed two other major tax law changes aimed at increasing business investment and improving the economic recovery. The two proposals would:

- Permanently extend the research and development tax credit, at a cost of $100 billion over 10 years.

- Provide for full expensing of most business investment in property and equipment in 2010 and 2011, at a cost of $30 billion over 10 years.

The President has suggested paying for these proposals, and an additional $50 billion in new infrastructure spending, by enacting the revenue raising proposals included in his budget. These proposals include tax increases on oil and gas companies and new taxes on the overseas earnings of U.S. companies.

Prospects:

Neither of these proposals is likely to be enacted this year. Many Democrats have no interest in reducing business taxes. While most Republicans are in favor of these changes and have supported the R & D credit and full expensing in the past, their number one priority right now is a permanent extension of all of the 2001 and 2003 tax cuts. In addition, most Republicans and major business organizations do not support the business tax increases proposed to pay for the two proposals.

5. "PATCHING" THE ALTERNATIVE MINIMUM TAX

Unless Congress acts this year, the individual alternative minimum tax (AMT) will revert to 2001 levels and will negatively affect more than 26 million taxpayers in 2010, up from 4 million taxpayers in previous years. Since 2001, Congress has passed a temporary AMT fix each year, known as "patching the AMT," which has limited the impact of the AMT. Failure to act again this year to patch the AMT will subject more than 26 million taxpayers to the AMT for 2010 and 2011.

Prospects:

Congress is expected to act before the end of the year to pass an AMT patch for 2010 and 2011.

6. EXTENDING VARIOUS EXPIRING TAX PROVISIONS

Congress is considering legislation to extend a long list of popular tax provisions which expired at the end of 2009 and need to be extended. These provisions include the R & D tax credit, the active financing provision, energy tax incentives, and a number of other individual and business tax provisions. The Senate bill would pay for this tax extenders bill by closing "tax loopholes for wealthy investment fund managers and large corporations" by raising the tax on carried interest and increasing taxes on oil companies.

Prospects:

There is a great deal of pressure on Congress to pass legislation to extend these expired tax provisions. This legislation has a good chance of passing this year, possibly in the lame-duck session after the elections.

7. ESTATE TAX

The 2001 tax cuts phased out the estate tax over a number of years, repealing it entirely for 2010. However, unless Congress acts by the end of this year, the estate tax will return to pre-2001 levels (an exemption of $1 million and a tax rate of 55 percent on monies in excess of $1 million). The President has proposed setting the estate tax rate at 2009 levels, with a $3.5 million exemption and a 45 percent rate. Republicans have proposed a $5 million exclusion and a 40 percent rate.

Prospects:

With estate taxes due to increase in 2011, Congress is under pressure to act before the end of the year. The most likely outcome is a temporary extension of rates at the 2009 estate tax levels.

8. INTERNATIONAL TAX PROVISIONS

Senate Democrats are pushing a bill to curb "tax breaks for corporations that ship our jobs overseas." The legislation is expected to be similar to the President's proposals to modify the foreign tax deferral and foreign tax credit available to U.S. corporations operating overseas.

Prospects:

Congressional Democrats believe the taxation of corporate foreign operations is a winning election strategy and they want to force a vote before this year's elections. However, there is little chance of final action this year.

The **Global Sage** Public Policy Advisory Group is headed by Bruce Thompson, a Washington veteran with more than three decades of experience working on public policy issues in both the public and private sectors. Bruce has been deeply involved in every significant public policy debate involving the financial services industry. He was Head of the Merrill Lynch Global Government Relations Office for 22 years. Before that, he served at the Treasury Department as Assistant Secretary for Legislative Affairs under Don Regan and Jim Baker. Prior to Treasury, he worked in the U.S. Senate for seven years.