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Bush Tax-Cut Puzzle Has 6 Pieces to Fit Together With Brackets

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Nov. 30 (Bloomberg) -- President Barack Obama and congressional Republicans plan to kick-start negotiations today at the White House over a possible extension of Bush-era tax cuts that are set to expire Dec. 31.

They will have to confront six areas of dispute dealing with taxes as well as issues such as renewing federal subsidies for extended jobless benefits that run out today. Some of the tax elements are subject to budget-balancing rules, which require offsetting tax increases or spending cuts to renew. Others must be approved by a two-thirds majority to fund with deficits. Still others weren't enacted under President George W. Bush or already have expired.

The Tax Coalition, a Washington group that includes anti- tax organizations such as Americans for Tax Reform and business trade associations such as the U.S. Chamber of Commerce, warned lawmakers yesterday that a delay in extending the Bush-era tax cuts would hurt the economic recovery.

"It's going to muck up economic decisions" and cause widespread selling of stocks as investors seek lower capital- gains tax rates before year-end, said Mark Bloomfield, president of the American Council for Capital Formation, a Washington group that advocates for lower taxes on investments. Consumers and investors "will be frozen because they don't know what the government's going to do."

Target: Highest Bracket

Groups including the AFL-CIO labor union back only an extension of the middle-class tax cut. AFL-CIO President Richard Trumka this month said it is "absolutely insane" to preserve lower tax rates at the top.

"We need to focus on creating jobs by giving tax breaks only to middle-class families," Trumka said earlier this month. "Millionaires and Wall Street already had their party, which tanked our economy and left Main Street stuck paying the bill."

Following are the six elements, their revenue implications and a description of where Obama and lawmakers stand.

The fight between Obama and congressional Republicans centers on whether to cap an extension of lower tax rates and higher credits adopted in 2001 for single taxpayers who earn more than $200,000 a year and couples earning more than $250,000. Obama supports the cap; Republicans and some Democrats don't.

The 2001 law carved a new 10 percent bracket from the 15 percent rate and reduced other marginal rates to 25, 28, 33 and 35 percent. In 2011, the 10 percent rate is scheduled to be absorbed into the 15 percent rate, and the other brackets will rise to 28, 31, 36 and 39.6 percent, respectively.

Credits, Subsidies

Lawmakers agree on preserving the 10, 15, 25 and 28 percent brackets for taxpayers earning less than $250,000, which requires an act of Congress. The government would forgo $66 billion in revenue in 2011 and $1.18 trillion across a decade by doing so. Budget rules allow these cuts to be financed with deficits.

There's also no dispute over preserving provisions such as a $1,000 child credit, relief from the so-called marriage penalty and subsidies for education, adoption and child care. Those provisions are permitted to add another $24 billion to the deficit in 2011 and $746.3 billion over 10 years.

Republicans support the extension of lower rates in the top brackets, along with abolishment of provisions that phase out deductions and personal exemptions for high wage earners. Under current law, Congress would have to raise taxes or cut spending elsewhere in the budget by about $21.3 billion for 2011 and $573 billion over the next decade to retain the 33 and 35 percent tax brackets. Alternatively, lawmakers can waive the budget law by declaring an emergency, which would require 60 votes in the Senate.

Alternative Minimum Tax

For married couples, the 33 percent rate currently applies to taxable income between $209,250 and $373,650, after which the top rate takes effect. If a couple had about $50,000 in deductions, for example, they'd have to earn about $425,000 a year to pay the top rates. Many would pay the alternative minimum tax instead.

While Obama and Congress clash over taxes for 2011, they are under pressure to act by Dec. 31 to roll back a $66 billion tax increase already on the books for 2010 because of the alternative minimum tax. The levy was created in 1969 to prevent 155 wealthy Americans from avoiding tax by claiming extensive deductions, credits and exemptions.

It replaces common deductions such as those for medical expenses and state and local taxes with a flat exemption. Amounts that exceed the exemption are taxed at a 26 percent or 28 percent rate, depending on the amount of income. Taxpayers who may owe the AMT must calculate their liability under both systems and pay the higher amount.

Unintended Consequence

Because the AMT wasn't indexed for inflation, over time it has come to affect Americans with more modest incomes, many of whom are surprised to find they owe it. Congress has spared these taxpayers with a series of annual "patches" that increase the flat exemption amount to account for inflation.

Lawmakers said Nov. 9 they are drafting legislation to set the 2010 exemptions at $72,450 for married taxpayers filing jointly and $47,450 for single taxpayers. The exemptions currently are $45,000 and $33,750.

If nothing is done, it would result in an average tax increase of $3,000 to $5,000 in 2010 for about 25 million households, most of whom have never paid the AMT, according to H&R Block Inc., the largest U.S. tax-preparation firm.

A one-year patch would cost the government about $66 billion in foregone revenue and can be financed with deficits under budget rules.

Capital Gains, Dividends

The 2003 tax law reduced taxes on most long-term capital gains to 15 percent from 20 percent. It also set a 15 percent rate for many dividends that had been taxed as ordinary income at an individual's top marginal rate. Those previous rates are slated to be reinstated in 2011 unless Congress acts, although assets held longer than five years would qualify for an 18 percent capital-gains tax rate.

Obama proposes preserving the 15 percent rates on both for individuals earning less than $200,000 and joint filers earning less than $250,000. He supports allowing the capital gains rate to revert to 20 percent for high earners. He also would cap the dividend tax rate at 20 percent rather than allowing dividends to be taxed as ordinary income. Budget rules don't provide for the 20 percent rate for dividends to be financed with deficits, so Obama or lawmakers would have to waive them or find an estimated $10 billion elsewhere in the budget for 2011, or $100 billion over 10 years.

Obama won enactment of higher taxes on investment income as part of the health-care law he signed in March. In 2013, a 3.8 percent Medicare tax will apply for the first time to investment income claimed by high-income taxpayers.

Business Tax Breaks

Republicans are seeking to keep the 15 percent rates in place for high-income taxpayers. That would require budget offsets of about $314.6 billion over 10 years or a waiver of the rules.

Congress also is struggling to renew dozens of expired tax breaks, about 80 percent of which benefit businesses. They include a research and experimentation credit popular with such companies as Dow Chemical Co. and Harley-Davidson Inc.

Another break is tax deferral on profits that companies including General Electric Co. and JPMorgan Chase & Co. earn from financing equipment sales or issuing credit cards overseas. Versions of the legislation also would extend the Build America Bonds program used by states and cities to finance things such as road building and repairs.

State, Local Taxes

A handful of tax breaks for individuals also are popular with lawmakers, the biggest being a deduction for state and local sales taxes.

Like the AMT patch, most of these tax breaks expired at the end of 2009, and lawmakers have been under pressure to renew them since. They've been unable to agree because Republicans, and a few Democrats, object to the revenue-raising proposals added to comply with budget rules, the largest of which calls for higher taxes on so-called carried interest.

Carried interest is the compensatory share of profits earned by managers of investment partnerships. It can qualify for lower capital gains rates even as the share is tied to the manager's labor rather than a capital investment. Democrats have framed the proposal as ending a loophole exploited by executives at private-equity firms and passed legislation taxing carried interest at the higher rates that apply to wages.

Carried-Interest Fight

Republicans have opposed the proposal with the help of the real estate and venture-capital industries. They argue that the change is so sweeping it would also raise taxes on family partnerships. They've also opposed other revenue offsets in the bill, including higher levies on oil and gas companies.

Dropping the carried interest provision would provoke outrage among Democrats who still control the House during the lame-duck session.

Senate Finance Committee Chairman Max Baucus of Montana said this month that he's committed to keeping the carried interest provision in the measure. Analysts say that would make it tough to find 60 votes in the Senate in support of dropping the proposal.

The funding puzzle is further complicated by the fact that a one-year extension would renew the breaks for 2010 only. Extending them through 2011 would more than double the cost.

Estate, Gift Taxes

There's no federal estate tax for 2010 because of a phase- out schedule established by the 2001 law; in its place is a complicated capital gains tax.

The expiration is sandwiched between two sets of rules for 2009 and 2011, which has perplexed lawyers, accountants and wealthy families.

In 2009, individuals had a $3.5 million tax-free allowance they could distribute to heirs; couples had a $7 million exemption. Amounts beyond those were subject to a top 45 percent tax rate. Next year, the estate tax is slated to return, with a higher top rate of 55 percent and a lower tax-free allowance of $1 million per individual. That would generate $34.4 billion in revenue for 2011, according to the Congressional Research Service.

Obama favors, and the House of Representatives has passed, permanently reinstating the 2009 rates and allowances.

Extending the 2009 parameters through 2011 requires no offsets.

Any long-term change that generates less revenue than a 55 percent rate and a $1 million exemption would require budget- balancing measures. A 45 percent rate in 2011 would generate $18.1 billion in revenue, according to the CRS.

Most Republicans favor repealing the estate tax, which would require $666.1 billion in revenue offsets over the next decade under the budget rules.

Phase-In Proposal

More recently, Republicans such as Senate Minority Leader Mitch McConnell of Kentucky have endorsed an approach advanced by Senators Jon Kyl, an Arizona Republican, and Blanche Lincoln, an Arkansas Democrat, to phase in a $5 million tax-free allowance and set the top rate at 35 percent. That would require up to $315 billion in budget offsets or a waiver.

No proposal yet has mustered the 60 votes needed to clear procedural hurdles in the Senate and pass.

The last major element of the debate involves Obama's tax policies rather than those of Bush. The 2009 stimulus bill created a new Making Work Pay tax credit that increased the paychecks of married couples by up to $800 in 2009 and 2010. That credit expires Dec. 31, along with the Bush-era tax cuts, and would cost about $61.8 billion a year to extend. It would require budget offsets. The stimulus measure also expanded refundable credits for the working poor.

Illinois Senator Richard Durbin, the No. 2 ranking Democrat, said on Nov. 28 that Democrats would insist on an extension of Obama's policies during negotiations. He also said Democrats would tie extension of federal subsidies for extended unemployment benefits to the tax discussion.

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