CCH Tax Briefing:

PRESIDENT-ELECT OBAMA'S TAX PROPOSALS: AN UPDATE

Special Report

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HIGHLIGHTS:

- ✔ *Lower And Middle Income Tax Cuts*
- ✔ *Higher Tax Rates At $200,000/$250,000-Plus Level*
- ✔ *Permanent AMT Patches*
- ✔ *Emergency Retirement Savings Relief*
- ✔ *Help For Homeowners In Foreclosure*
- ✔ *New Worker Tax Credit*
- ✔ *Permanent Research Credit*
- ✔ *Corporate Loophole Closures*
- ✔ *More Incentives To "Go Green"*
- ✔ *Estate Tax $3.5 Million Exclusion*

Inside

President-Elect Brings Ambitious Tax Policy Agenda To Washington

On January 20, 2009, Barack Obama will take the oath of office as the 44th president of the United States. Federal tax policy is guaranteed to be at the forefront of President Obama's agenda. Democrats in Congress are preparing an economic stimulus package, which they hope to have ready for the new president's signature on January 20. It is likely to include significant individual and business tax incentives. The stimulus package may also include tax incentives for individuals and businesses to "go green" along with a huge infusion of federal funds for state and local infrastructure spending.

Impact *The president-elect is counting on a stimulus package large enough to jolt the economy out of what some are calling the worse slowdown since the 1930s. One way to jump start the economy in the view of the incoming administration is to get more money into taxpayers' hands, thereby increasing the consumer spending needed to drive the economy.*

Increasingly, there is talk on Capitol Hill of some sort of payroll tax credit or temporary employment tax holiday early in 2009, aimed at helping lower and middle income wage earners and self-employed individuals. For higher income individuals, the news appears to be mixed; they are likely to see a tax hike over the next four years, but probably not in 2009. The president-elect reportedly has been moving away from accelerating into 2009 the 36 percent and 39.6 percent individual marginal income tax rates that are set to return after 2010. He also has been leaning toward keeping the capital gains top rate at 15 percent for everyone, rather than having it revert to 20 percent in 2009 for higher-income individuals.

Caution *Higher-income earners, however, could find themselves paying more in employment taxes in 2009. Obama has indicated his support for a "payroll surtax," possibly as high as four percent, on compensation above $250,000.*

INDIVIDUALS

During the campaign, Obama promised a "middle class tax cut." "No family making less than $250,000 will see their taxes increase," the president-elect frequently said. Conversely, families making more than $250,000 and individuals making more than $200,000 can expect a tax increase.

The president-elect's middle class tax cut appears to be three-pronged:

First, Obama will renew the 10, 15, 25, and 28 percent individual tax rates created by the *Economic Growth and Tax Relief Reconciliation Act of 2001*

(EGTRRA) that are set to sunset after 2010. However, the top two rates under EGTRRA (currently 33 percent and 35 percent, respectively) would revert to 36 percent and 39.6 percent, respectively, at some point.

Impact *Avoiding tax increases on families making less than $250,000 would apparently apply to joint filers. The threshold for one-parent families (heads of household) is not spelled out but would presumably fall between $200,000 and $250,000. Obama's statements so far have also left unclear whether the cut-off amounts apply to wages, gross income, adjusted gross income, or taxable income. Current inflation-adjusted income tax brackets for 2009 set the 33 percent rate to begin at $208,850 for joint filers and $171,550 for single individuals; and the 35 percent rate to begin at $372,950 for both joint and single filers.*

Second, and more immediate, Obama has proposed a new refundable "Making Work Pay" tax credit. One proposal is that this credit would offset Social Security tax; however, the Obama transition team may be exploring other approaches. Income thresholds likely would apply. The thresholds under consideration seem to be $75,000 for single taxpayers and $150,000 for married couples filing jointly.

Impact *The Making Work Pay credit is projected by the president-elect to generate rebates of roughly $500 for individuals and $1,000 for married couples filing jointly. According to the president-elect, the first round of these tax credits could be distributed by the IRS based on returns filed for tax year 2007.*

The president-elect has also proposed restoring the personal exemption phase-out (PEP) and itemized deduction limitation (Pease limitation) for individuals making over $200,000 and families with incomes above $250,000.

"Lower and middle income taxpayers will likely receive some sort of tax cut in 2009. The news for higher income individuals appears to be mixed; they will likely see a tax hike over the next four years, but probably not in 2009."

Impact *Taking into account restoration of PEP and the Pease limitation, the top marginal individual income tax rate would effectively be above 40 percent.*

Third, a handful of tax breaks – some already presented and others possibly still under wraps – would give relief to middle and lower-income taxpayers, effectively lowering their taxes from current levels. These measures could include introducing a 10 percent mortgage interest credit for non-itemizers, expanding the earned income tax credit, raising education credits, expanding the child credit, and providing tax relief for retirees.

The tax break that Obama has promised to retirees involves effectively eliminating taxes for senior citizens making less than $50,000 a year. Further details on this proposal have not yet been released.

Comment *One unanswered question under Obama's planned tax cut for seniors is how capital gains and required minimum distributions from retirement savings would figure under any $50,000 cap. Another is whether those retirees who just miss the cut-off would receive a partial benefit.*

Timing. An increase in the tax burden for higher-income individuals is now a given. The only questions that remain are "how much" and "when." Since Election Day, the odds have been shrinking that any tax increase would be made retroactive to January 1, 2009, due to the fragile state of the economy. Even a midyear increase is unlikely, although not out of the question, both for the higher income tax brackets and capital gains. Immediate tax breaks for middle and lower income taxpayers, such as payroll tax rebates, however, are unlikely to be extended to upper-bracket taxpayers.

Impact *Executives with deferred compensation packages should now consider the impact of recognizing that income under a higher income tax rate structure. Some practitioners are already advising strategies that minimize the use of deferred compensation in favor of immediate cash and stock bonuses, tax-free and taxable fringe benefits.*

AMT

The record-high federal budget deficit will likely prevent Obama and Congress from permanently repealing the alternative minimum tax (AMT). Instead, the president-elect has indicated his support for continuing and possibly making permanent the annual inflation-adjusted AMT "patch."

Reminder *The AMT patch for 2008, which was enacted in the Emergency Economic Stabilization Act (P.L. 110-343) retroactive to January 1, 2008, sets the AMT exemption amount at $69,950 for married couples filing jointly and surviving spouses* *and $46,200 for unmarried individuals filing separately.*

Impact *If the pre-EGTRRA tax rates of 36 percent and 39.6 percent return in an Obama Administration, some higher-income taxpayers would no longer be within reach of the AMT because of their higher regular tax liability.*

CAPITAL GAINS/ DIVIDENDS

Higher-income individuals will likely pay more in capital gains and dividend taxes in an Obama Administration. Again, the only issue seems to be "when." The concern is that an immediate increase in the capital gains rate would further depress an already battered stock market. The president-elect has proposed a 20 percent capital gains and dividend tax rate for taxpayers in the top two income tax brackets, adjusted to affect only individuals making over $200,000 and families making over $250,000.

Reminder *For 2008 through 2010, qualified dividend income and capital gains tax rates arecurrently zero percent for taxpayers in the 10 and 15 percent income tax brackets and 15 percent for taxpayers in the higher tax brackets.*

Impact *Many retirees continue to count on an income stream from dividends, making any extension of the capital gains rates to dividends good news. For individuals in the higher brackets, and not yet retired, the rate changes add a new twist to whether retirement savings should be maximized through tax-deferred accounts that are taxed as ordinary income when withdrawn or through taxable accounts in which capital gains and dividends are taxed at a lower rate.*

The president-elect has also indicated his support for eliminating all capital gains taxes on investments in small and start-up firms but has not yet discussed the specifics of this incentive.

Impact *Under current law, taxable gain on the sale of "qualified small business" stock held for more than five years by an original investor is reduced 50 percent. A qualified small business can have assets as high as $50 million. Another existing provision treats losses on the sale of S corporation stock as ordinary, instead of capital, losses, up to $50,000 per taxpayer.*

Comment *The top rate for capital-gains from collectibles presumably would remain at 28 percent and the rate on unrecaptured Section 1250 gain at 25 percent.*

RETIREMENT

The recent stock market crash has caused many Americans sleepless nights over the state of their retirement portfolios. The president-elect has indicated his support for temporarily suspending the required minimum distribution (RMD) rules for IRAs, 401(k)s and other arrangements to help retirees retain a larger portion of their savings by not having to withdraw the funds at the bottom of the market. Obama has also proposed relaxing the rules that strongly discourage early distributions from IRAs and other arrangements, possibly allowing distributions of 15 percent, up to $10,000, from retirement accounts without penalty for 2008 and 2009. Coordination of this withdrawal benefit with current emergency withdrawal rules (for health needs, hardships and so on) remains to be hammered out.

Impact *Accessing retirement savings for immediate needs, whether because of a job loss, higher mortgage costs or another crisis, should be a tactic of last resort. If the funds are not replaced, they will not be there for retirement. If the withdrawals are to be considered a loan under any proposed law change, the failure to eventually repay those amounts will subject the taxpayer to income tax and penalties.*

Caution *The deadline for 2008 RMDs is December 31, 2008 (April 1, 2009, for those who first turn 70 1/2 in 2008), leaving Congress little time to act.*

OBAMA-SUPPORTED TAX PROPOSALS

Individuals	• Payroll tax holiday or offset worth $500 ($1,000 for families) • Extend 10, 15 and 28% income tax rates • Let top rates increase to 36 and 39.6% • Make AMT patch permanent (at least for short term) • 10% mortgage interest credit • Expanded earned income tax credit • Enhanced tax incentives for education • Eliminate tax on seniors earning less than $50,000
Businesses	• Extend Section 179 expensing and bonus depreciation • Eliminate capital gains on investments in start ups • Create a permanent research credit • Small business credit for health care premiums • Possible corporate tax rate reduction in return for loophole closing
Energy	• Expand and create energy tax breaks for conservation and renewable fuels • Possible reduction in tax benefits for oil and gas companies • Possible windfall profits tax
Estate Tax	• Make permanent an estate tax with $3.5 million exclusion and top rate of 45%

Comment *The Treasury Department, in response to inquiries from several lawmakers, recently indicated it is considering ways to "administratively ameliorate" the RMD issue. However, the Treasury did not describe what relief methods are being considered.*

MORTGAGE CRISIS

The president-elect has promised further help for homeowners in or on the brink of foreclosure. During the campaign, he proposed that lenders temporarily delay foreclosures for 90 days and endorsed the idea of giving bankruptcy judges more powers to modify the terms of mortgages. Few details have emerged since the election. Although the government has initiated a voluntary foreclosure rescue program, without additional legislation the vast majority of lenders (those with securitized investors) are contractually bound not to delay foreclosures or enter into workout arrangements.

Comment *Obama could act quickly on January 20 and approve a foreclosure rescue plan already prepared by the FDIC. The FDIC has proposed using some of the $700 billion appropriated for the financial markets rescue package to have the U.S. guarantee troubled mortgages. On the tax side, the Treasury is currently working to ease the concern of real estate mortgage investment conduits (REMICs) and real estate investment trusts (REITS) over the treatment of appreciation rights and other workout issues. Efforts are also being made to reconcile treatment of homeowners who issue appreciation-rights debt instruments for cash and those whose obligation arises under a workout agreement.*

BUSINESSES

Businesses can expect a mixed bag of tax cuts under an Obama Administration. Aside from providing a short-term fix for the economy, any tax breaks for business are likely to be considered by the Obama Administration based on whether they will create jobs. Sources close to the transition team have indicated that, if a particular incentive enables a business to hire more workers, it will be on the short list of possible business tax breaks.

Impact *With direct bailouts taking care of many large businesses, relief for small businesses -- often called the prime engine for job growth in the national economy -- most likely will be in the form of tax breaks. Enhanced expensing and extended bonus depreciation are prime vehicles that are being identified to provide this relief. So is the proposal to eliminate all capital gains on start-up company stock, as previously mentioned.*

The president-elect has appeared to endorse lowering the U.S. corporate tax rate, currently the second highest in the industrialized world, as long as unspecified business tax "loopholes" are closed. However, the federal government's demand for revenue may preclude a corporate tax cut in 2009.

New worker credit. As a short-term stimulus, Obama has discussed a $3,000 refundable credit during 2009 and 2010 for each full-time employee added to the workforce by existing businesses. However, businesses that move jobs outside the U.S. could find some current but unspecified tax benefits curtailed or eliminated.

Code Sec. 179 expensing and bonus depreciation. The president-elect has indicated his support for extending the first-year expensing limitation of $250,000 through 2009. He also appears to have no objection to legislation that already has been proposed in the lame-duck Congress to extend 50-percent bonus depreciation into 2009.

Research credit. Both sides of the aisle have consistently called for making the research and development (R&D) tax credit permanent. When push came to shove, however, a permanent extension of the R&D credit was too expensive for many lawmakers. Obama has emphasized American innovation as key to continued prosperity. As an incentive to jump-start the economy, a permanent R&D credit has the best chance in a long time for passage in 2009.

MAJOR TAX RATES SET TO END AFTER 2010

Income Tax Brackets	Top rate of 35% reverts to 39.6%
	33% rate rises to 36%
	28% rate rises to 31%
	25% rate rises to 28%
	15% rate captures present 10%
	10% rate eliminated
	Obama plan: Let top two rates rise; retain 10, 15, 25 and 28% rates
Capital Gains	15% rate rises to 20%
	0% rate rises to 15%
Dividends	15/0% rates rise to ordinary income tax rates (high of 39.6%)
	Obama plan: Let rates rise for higher-income individuals only; retain lower rates for other individuals; 0% rate for all taxpayers investing in small business start ups
Estate Tax	No estate tax in 2010; reverts to $1 million exclusion and top rate of 55% after 2010.
	Obama plan: Freeze estate tax at 2009 level, with $3.5 million exclusion and 45% top rate
Child Credit	$1,000 credit returns to $500
	Obama plan: Make the credit refundable with additional credit for child care for lower-income taxpayers; size of credit for others remains uncertain

Impact *One way to curtail tax incentives for businesses that move jobs outside the U.S. would be to place new limits on the use of foreign tax credits. The Obama transition team reportedly is considering this route.*

Comment *Still uncertain at press time is the fate of the proposed bailout for the nation's big three automakers and a pension bill. President Bush has signaled his unwillingness to use any of the $700 billion appropriated by Congress for the financial markets rescue package to aid the troubled automakers. Any automaker bailout package is likely to include limits on the deductibility of executive compensation. The pension bill would temporarily suspend required minimum distributions from IRAs, 401(k)s, and similar arrangements along with giving many hard-strapped pension plans some funding leeway, as well as other relief.*

EXECUTIVE COMPENSATION

The *Emergency Economic Stabilization Act (EESA)* generally limits the deductibility of executive compensation for financial institutions participating in the rescue program. EESA's limits on executive compensation could foreshadow more expansive curbs on the deductibility of executive compensation and the tax treatment of deferred compensation. Legislation has already been introduced in Congress to cap the deductible executive compensation at 25 times the pay of the business' lowest-paid employee. Obama may support these measures from the perspective of leaving more money on the table for jobs creation.

WORKER CLASSIFICATION

While in the Senate, Obama supported calls to tighten the rules for classifying workers as independent contractors, rather than as employees entitled to benefits and the payment of the "employer's share" of Social Security taxes. Because of the emphasis on jobs, further restrictions on the use of independent contractor status should be expected.

HEALTH CARE

The president-elect promised on the campaign trail to make affordable heath care available to all. At this time, details are few. Obama may propose some sort of private-public partnership. However, the cost of health care reform could push it to the back burner until the economy recovers.

Comment *Sen. Max Baucus, D-Mont., chair of the Senate Finance Committee, recently unveiled what could be a blueprint for health care reform in 2009. The Baucus plan would create a national "health insurance exchange." The exchange would be a marketplace for consumers to compare and purchase plans. Small businesses could receive some yet to be defined tax incentive.*

Impact *Health Savings Accounts (HSAs), which were heavily promoted by the Bush Administration as "consumer-driven" health care, are in jeopardy. One likely outcome is that individuals who have contributed to these tax-favored accounts would be allowed to keep whatever amounts are already in the account. Another outcome, however, may be to allow a modified version of HSAs as a supplemental form of insurance.*

ENERGY

Tax incentives are very likely to play a large role in encouraging the development of alternative energy. Obama has endorsed expanding current tax breaks for producers of wind, solar, biomass, and other alternative energy sources to create "green collar" jobs. Another proposal would send emergency energy rebates to individuals to help pay for home heating costs.

Comment *During the campaign, the president-elect expressed support for a windfall profits tax on oil companies. However, it appears that he has backed away from this proposal at least for the present.*

ESTATE TAX

Under EGTRRA, the estate tax exclusion is $2 million for 2008 and $3.5 million for 2009, with a maximum tax rate of 45 percent. EGTRRA repeals the estate tax entirely for 2010, but reinstates it in 2011 at pre-EGTRRA levels: a $1 million exclusion and a top rate of 55 percent. Obama has proposed to establish the exclusion at $3.5 million per individual ($7 million per couple) with a top rate of 45 percent.

Impact *According to the president-elect, his proposal would effectively repeal the estate tax for 99.7 percent of estates and would reduce the number of taxable estates by 84 percent relative to 2000. Despite this effective repeal, however, no mention has been*

Possible Revenue Raisers in Future Tax Bills

- Codification of economic substance doctrine
- Change tax treatment of carried interest
- Repeal LIFO method of accounting
- Limit or repeal the Code Sec. 199 deduction
- Windfall profits tax on oil and gas companies
- Limit deductibility of executive compensation
- Higher IRS penalties
- New limits on foreign tax credits
- Further delay in worldwide allocation of interest
- Crackdown on offshore tax evasion
- More limits on corporate inversions
- Tightened safe harbors for independent contractor status

made to do away with allowing beneficiaries a stepped-up basis pegged at date–of-death for any asset received from an estate.

Comment *The total inflation rate from 2001 until 2008 is 20.55 percent. If an estate tax exclusion of $1 million in 2001 were indexed for inflation, it would have been worth $1,205,500 in 2008 dollars.*

REVENUE RAISERS

Several of Obama's revenue raisers are recycled proposals from past years. He has indicated his support for codifying the economic substance doctrine and taxing carried interest as ordinary income. The president-elect has also discussed, but with little detail, cracking down on offshore tax havens and broadening the corporate tax base. Some lawmakers have proposed further restrictions, or eliminating entirely, the Code Sec. 199 domestic production activities deduction and repealing the LIFO method of accounting for publicly-traded companies as a tradeoff for a lower overall corporate tax rate.

MORE PROPOSALS

The president-elect has discussed many other tax proposals, often without any elaboration. These include:

- Expanding the Saver's Credit;
- Simplifying tax filing for individuals;
- Creating a new refundable mortgage interest tax credit;
- Enhancing and making refundable the child and dependent care tax credit;
- Expanding the Earned Income Tax Credit; and
- Creating new education tax credits.

NEW LEADERS

Obama has begun to unveil his financial and tax team. He has named Timothy Geithner, currently head of the Federal Reserve Bank of New York, to serve as Treasury Secretary. Former Federal Reserve Chair Paul Volker has been tapped to lead the president-elect's Economic Recovery Advisory Board. Lawrence Summers, who served as Treasury Secretary under Bill Clinton, will head-up Obama's National Economic Council. Christina Romer, an economics professor at the University of California (Berkley) will chair Obama's Council of Economic Advisors.