SMALL BUSINESS LEGISLATIVE COUNCIL

# SBLC WEEKLY

July 11, 2011 Volume XIII, Issue 26

## *SOMEBODY IS GOING TO BLINK*

In classic Washington fashion, we are following the bouncing ball as "negotiators" in the debt ceiling increase tableau play out the final stages of their negotiations. On a given day, one side or the other appears ready to blink on a major negotiating point. Then they pull back, but not all the way back. Thus the policy option circle tightens with each round. And, of course, it would not be Washington, unless we had a couple of breakdowns in the talks followed by phoenixes rising from the ashes.

The principal issue for the Republicans is whether there are revenue increases in our future. Over the last week or two, the ground has shifted just a bit on what constitutes a tax increase. Eliminating "loopholes" otherwise referred to as tax expenditures otherwise known as the deduction and credits taken primarily for engaging in some particular behavior (e.g. ethanol credit) has gained a little bit of traction as a "blinking" possibility.

On the other hand, the unexpected curve ball might be taxing the super-rich. The "easiest" way to blink would be to further restrain their ability to itemize deductions. Otherwise you would have to go after their tax rate, a much more difficult change to "blink" away. Out in left field but perhaps more palatable might be something with the Alternative Minimum Tax (AMT). Don't forget that it was brought into the code back in the 1960's to restrain the super-richs' ability to use deductions and credits. Because of a drafting flaw – no inflation indexing of income thresholds – it has long since taxed the middle class. If you wanted to dress up a change in blinking clothes, instead of dealing directly with tax rates or deductions and credits under the regular tax, you could "reform the AMT" by raising the income thresholds and indexing them, but, oh by the way, raise the AMT rates or tighten up the deductions and credits one can take for AMT purposes.

In recent days, a "big deal" has come and gone as an option. The big deal would have meant long term, really, really legitimate deficit reduction. The biggest impact on small business would have been a complete overhaul of the tax code. Hard to say what the impact would be however. The funny thing about this particular big deal is that deficit reduction advocates said that in past deals, we got the tax part as a permanent change but the spending cuts faded fast. In the current big deal it looked more like the spending cuts were front end loaded and the likelihood of tax changes more tenuous. But, at least for today, that is off the table and we are back to a "little deal."

In little deal land, there is still the question of blinking. Among the tax items that the Administration has floated are two that would have an impact on small business – LIFO repeal and elimination of the domestic production activity income deduction. (The IRS calls it DPAD.)

Generally speaking, LIFO would most hurt long time successful small businesses. The Last In – First out (LIFO) method assumes the items of inventory you purchased or produced last are the first items you sold, consumed, or otherwise disposed of. Items included in closing inventory are considered to be from the opening inventory in the order of acquisition and from those acquired during the tax year.

The LIFO inventory accounting method has been a common method for many years and it is particularly useful in inflationary times. There are other methods of inventory accounting such as First In-First Out (FIFO). Each method produces different income results, depending on the pricing trends at the time. In times of inflation, when prices are rising, LIFO will produce a larger cost of goods sold and a lower closing inventory. Under FIFO, the cost of goods sold will be lower and the closing inventory will be higher. However, in times of falling prices, the opposite will hold true.

Typically, a business carries a LIFO reserve on its books that reflects the amount of taxable income that has been "deferred" by using the method. This amount reflects the difference between what the dollar value of the inventory would have been under FIFO and the LIFO value.

If the LIFO method is repealed, the LIFO reserve is eliminated and the taxable income is increased immediately but the taxes due usually can be paid over a four year period under change of accounting rules. Discussions about LIFO repeal usually include some discussion of a longer transition rule to stretch out the period in which the business has to pay the accrued tax liability.

Don't ask me why the Administration has chosen LIFO repeal as a stalking horse. It has been in the President's proposed fiscal years' budgets but nobody pays any attention to those. My theory is it is because LIFO repeal has a (albeit dubious) 'bi-partisan" genesis.

In the 109th Congress, then Senate Majority Leader Bill Frist (R-TN) unveiled a package of gas tax relief items including a $100 gas tax rebate for consumers and authorization for drilling in the Arctic National Wildlife Reserve (ANWR). To pay for the lost tax revenues from the rebate, the proposal included a repeal of the Last In-First Out (LIFO) inventory accounting method. He quickly withdrew the proposal in the face of significant opposition. To the surprise of many, Senator Frist's proposal was a simple but complete repeal of the LIFO method for all. Many expected a reprise of a version in a different bill from 2005, which would have repealed it just for the oil companies.

Eliminating DPAD is also something that would have more of an impact on businesses in certain sectors that have proven to be durable during the recession. The deduction relating to domestic production activities was enacted in October 2004 as part of the "American Jobs Creation Act". Basically, it allows a business to reduce its taxable income for a portion of the income that comes from domestic production activity.

There were two big points for us when it passed – the definition of production is generous and pass through entities may use it as well. The deduction started out as equal to three percent of income from domestic production activities for 2005 and, in 2010, it reached a maximum of nine percent of such income – a pretty good number! The activities eligible for the deduction include not only the manufacture of personal property such as clothing, goods, and food, but also software development, film and music production, production of electricity, natural gas, or water, construction, and engineering and architectural services. (The DPAD is often referred to as the Section 199 deduction – not to be confused with Section 179 direct expensing!).

My concern with Section 199 is that "we hardly knew ya." I am not sure tax data accurately reflects its value to small business. The percentage was modest at the beginning and then we fell into the recession. I think the 2010 tax year was the first time, with the nine percent number, someone might say, "Hey, this thing makes a difference." Of course, the government won't know about 2010 returns for a while.

### *CONSUMER PRICE INDEX*

One of the items under discussion is changing the type of Consumer Price Index (CPI) (yes, there is more than one) that is used for various federal benefit programs like Social Security. The idea is based on the belief the current CPI that is used does not reflect real world economic behavior and is thus too generous.

The index currently in use is the Consumer Price Index for All Urban Consumers (CPI-U). It measured the average change over time in the prices paid by urban consumers for a "market basket" of consumer goods and services. One of the other indices is the Chained Consumer Price Index for All Urban Consumers (C-CPI-U). The "regular" CPI uses a static basket of goods; the "chained" one reflects the effect of any substitution that consumers make across item categories in response to changes in relative prices. The common example is that when the price of beef goes up, consumers switch to chicken if it is cheaper. So if you have a static basket of goods, you are not capturing the adjustment we make in the real world when prices go up.

There are a variety of other plusses and minuses for small business if there is a switch. The wage base for the social security portion of the FICA taxes is capped. The cap is tied to the CPI. If wage base grew less quickly, that would be a good thing (In fact, it has not gone up for two years).

Income tax brackets are tied to the CPI as well.

Some of the provisions that allow small business owners to contribute to their pensions are also tied to CPI. They too have been flat, and if the logic of changing the CPI holds true, future increases would be less.

***DEBIT CARD SWIPE FEE RULE***

While the SBLC Weekly took a break, the Federal Reserve did issue its final rule on the limits for “interchange fees” (often referred to as “swipe” fees) that debit card issuers can charge retailers and others for processing debit card transactions. The “Dodd-Franks” financial system reform law included a provision to direct the Fed to set the limit.

The rule sets a cap on transaction fees composed of a base (minimum) component of 21 cents and an ad valorem component of 5 basis points of the transaction. "Ad valorem" means that it varies based on the amount of the transaction. A basis point is 1/100 of 1 percent. So you have a flat amount for each transaction regardless of the amount of the transaction plus a variable amount. A $39 transaction would generate the 21 cents fee plus 1.95 cents ($39.00 x .0005) for a total transaction fee of 22.95 cents for that $39 transaction. A $390 transaction would general a fee of 40.5 cents. In addition, there would be a fraud prevention adjustment of 1 cent per transaction conditioned upon the issuer adopting effective fraud prevention policies and procedures.

The rule establishes an effective date of October 1, 2011, for the interchange fee standards. There are a few other nuances in the final rule but that is the main issue. This is an increase relative to the proposed rule. The proposed rule had two options: one based on each issuer's costs, with a safe harbor (initially set at 7 cents per transaction) and a cap (initially set at 12 cents per transaction); and the other a stand-alone cap (initially set at 12 cents per transaction). The law itself did not set a specific formula; all it said was the Fed will issue a rule that "shall be reasonable and proportional to the cost incurred by the issuer with respect to the transaction."