PRESIDENT’S DEFICIT REDUCTION PROPOSAL

The President has put forth a plan entitled, “Living Within Our Means and Investing in the Future.” It assumes that the Committee of 12 will come up with the $1.2 trillion in spending cuts. In addition the President’s proposal includes nearly $580 billion in cuts and reforms to mandatory programs, of which $320 billion is savings from Federal health programs such as Medicare and Medicaid. The plan also realizes more than $1 trillion in savings over the next 10 years from the drawdowns in Afghanistan and Iraq. There are $430 billion in interest savings. The plan calls for the Congress to undertake comprehensive tax “reform” that increases revenues by $1.5 trillion.

Looking at the new spending cuts and health program savings, nothing jumps out at me as small business generic. Not a surprise, therefore, it is the tax matters that constitute the heart of the proposal of interest to the majority of small businesses. (The potential spending cuts that would have an impact on small business among the $1.2 trillion are hard to come by, but you can be sure that some will emerge from the Committee of 12 discussions with their heads on the chopping block.)

TAX REFORM

The President’s proposal calls for comprehensive tax code reform. As with all such calls for tax reform, the devil for small business would be in the details. This is primarily the result of the fact many small businesses pay taxes based on the individual tax rates since they operate as “pass through” entities such as sole proprietorships, partnerships, and S Corporations, and tax reform proposals generally call for eliminating business deductions and credits across the board, but only provide relief for C Corporation in terms of a lower tax rate. The President did not provide details beyond the “Buffett” principle.

The principle is “No household making over $1 million annually should pay a smaller share of its income in taxes than middle-class families pay.”

In addition to calling for tax reform, the President did list a variety of “loopholes” he would close as an alternative to reform or as part of the reform effort. These are few that I thought are of the most general applicability to small business.

FUTA SURTAX

You may recall that just this year, a long time “temporary” Federal Unemployment Tax Act (FUTA) surtax expired. The surtax was 0.2 percent. The President would revive it and make it permanent. Currently, employers pay at the end of the year a “net” 0.6 tax for each employee on the first $7,000 of wages. (The FUTA tax is actually 6 percent (it would be 6.2 with the surtax restored), but the employer receives a 5.4 percent credit for unemployment taxes paid to the state. The 0.2 surtax works out to additional $14 per employee per year.

(In another portion of the President’s proposal there is actually some relief for employers in states where the state has borrowed heavily from the federal government to pay unemployment compensation claims. When that happens, the state rate goes up for employers in that state. The President has proposed some modifications that might hold the rate down for employers in those states.)
INDEPENDENT CONTRACTORS

In industries in which there is a debate about whether individuals who provide services to a business are employees or independent contractors, a cease fire of sorts was brokered in the late 1970’s. A provision known as Section 530 provided safe harbors for the use of independent contractors in industries that had traditionally engaged independent contractors. Section 530 also prevents the Internal Revenue Service from writing rules on how to classify individuals as independent contractors or employees. The theory was that the IRS was not objective, and it should be left to Congress to establish fair and objective rules. The President’s proposal would effectively dismantle Section 530.

LIFO

The Last In First out (LIFO) method of accounting 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. 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. In times of falling prices, the opposite holds 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. The President would repeal the ability to use LIFO. (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.)

ESTATE TAX

The President proposes a return to the estate tax rate and exemption level that was in place in 2009.

At that time, the top rate was 45 percent and the individual exemption was $3.5 million. Currently, the exemption is $5 million per person and the top tax rate is 35 percent through 2012. Presumably if the President’s recommendation were enacted, some of the other beneficial aspects of the current temporary law would be lost as well. For example, under prior law, couples had to do complicated estate planning to claim their entire exemption. The current temporary law allows the executor of a deceased spouse’s estate to transfer any unused exemption to the surviving spouse without such planning.

INDIVIDUAL TAX INCREASES

Since many small businesses do pay on the individual rate structure, in theory anything that changes that structure has some impact on their retained earnings. If you worked with the level suggested by the President’s “Buffett Rule,” of $1 million in income, there are very few small businesses that would experience any direct change in their tax liability. But the proposal does not actually call for a tax bracket starting at $1 million.

Instead, in the section of the President’s proposal outlining the alternative ways to raise revenue if you do not achieve Buffett Rule tax reform or as options to be considered as part of it, the President’s proposal references the $250,000 income level. The proposal would allow the top marginal rate to return to 39.6 percent from 35 percent for incomes over $250,000. The proposal would also limit the tax rate at which high-income taxpayers can reduce their tax liability to a maximum of 28 percent, affecting only married taxpayers filing a joint return with income over $250,000 (at 2009 levels) and single taxpayers with income over $200,000. This limit would apply to: all itemized deductions; foreign excluded income; tax-exempt interest; employer sponsored health insurance; and selected above-the-line deductions.

The President said he is offering these suggestions “To begin the national conversation about tax reform … as well as move the tax system closer to observing the Buffett Rule.”