SMALL BUSINESS LEGISLATIVE COUNCIL

SBLC WEEKLY

November 7, 2012 Volume XIV Issue 29

FINDING THE MIDDLE GROUND

President Obama has been re-elected, the Democrats have retained a majority in the United States Senate, and the Republicans have retained control of the House of Representatives.

The instant small business headlines:

**Health care reform will take effect in 2014*
**Taxes will go up, as soon as January 1, 2013 for those making $250,000 or more*
**New regulations in environmental, labor relations and workplace safety and health can be expected in 2013*
**House Speaker John Boehner holds the key to bipartisanship*
**The filibuster is a good thing*
**The road to deficit reduction probably leads through tax reform.*

FISCAL CLIFF

President Obama said during the campaign that the pending defense cuts would likely be revised during the lame duck and that the impact of the expiring tax relief on the middle class would be mitigated.

The President's incentive to find a bipartisan package during the lame duck session is to clear away the economic uncertainties so he can enter his second term with a "running start."

The question is what are the more fiscally conservative members in the House of Representatives inclined to do? It would seem their leverage is limited notwithstanding the fact many of them are coming back and they will retain the House majority. If they refuse to cooperate, deep defense cuts take effect on January 1, 2013 and all of the expiring tax relief (tax increases) take effect in on January 1, 2013 – automatically. Speaker John Boehner (R-OH) will have his hands full nevertheless because the rest of his caucus will not come easily to the negotiating table.

Will there be a package? I believe there will be one.

The most likely candidate for lame duck relief is the Alternative Minimum Tax (AMT) situation and the extension of the AMT income "patch." This is the temporary increase in the incomes levels at which the AMT kicks in. As you recall, the last patch actually expired at the end of 2011, so if the patch is not re-applied some of us are already at risk. I expect the patch to cover 2012 and 2013. (The amounts would be $50,600 for individuals and $78,750 for joint returns in 2012 and $51,150 and $79,850 respectively for 2013.)

Perhaps one of small business issues with the best prospects in the lame duck session is a renewal of a generous direct expensing allowance under Section 179 of the tax code. The reason is because a) it has historically enjoyed strong bipartisan support and b) the President and Democrats are going to want to point to some specific small business relief in the lame duck package to offset tax relief haircuts elsewhere. Section 179 of the tax code allows businesses to write off the amount of equipment and asset purchases in the year of purchase up to a certain amount as long as the business does not spend more than a specific total amount on such purchases in a year. We have been riding a wonderful wave of temporary increases that is about to come to an end at the end of 2012. Public Law 111-312, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (TRUIRJCA) permits taxpayers to use a direct expensing allowance in 2012 of $125,000. The $125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $500,000. The $125,000 and $500,000 amounts are indexed for inflation. As a result, for 2012, the adjusted allowance is $139,000 and the phase out is $560,000. ***At the beginning of 2013, the amounts revert to pre-2003 levels of $25,000 and $200,000 without inflation indexing.*** I am thinking the current levels will be extended. Much as I would like to see a permanent increase, I do not think that is in the cards.

Estate tax relief may be the biggest victim of the outcome of the election. While the President and the Democrats will probably not let it slide all the way back to its pre-2001 version, the relief is going to be modest.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (TRUIRJCA) extended the estate tax relief provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) with modified amounts and created some new provisions. Currently, we have a temporary exemption at $5 million per person and $10 million per couple and a top tax rate of 35 percent for the estate, gift, and generation skipping transfer taxes through the end of this year. The exemption amount was indexed beginning in 2012 and it is $5,120,000. Under prior law, couples had to do complicated estate planning to claim their entire exemption. TRUIRJCA allows the executor of a deceased spouse's estate to transfer any unused exemption to the surviving spouse without such planning, effective for estates of decedents dying after December 31, 2010.

All of the extensions, modifications, and new provisions expire December 31, 2012 and we go back to pre-EGTRRA law with a single graduated rate schedule with a top rate of 55 percent and a single effective exemption amount of $1 million applies for purposes of determining the tax on cumulative taxable transfers by lifetime gift or bequest.

I would not be surprised if the upper limits of compromise are around the 2009 level range of $3.5 million as the exemption and a 45 percent top rate. It will be a good day if we can hang on to spousal portability and inflation indexing. If we can get permanent relief, it would be an incredibly good day.

It is hard to imagine any scenarios under which the top individual marginal rate does not go back up to 39.6 percent from its current temporary 35 percent for incomes over $250,000.

It would seem likely that Speaker Boehner would try to hold on to some other expiring tax relief provisions. One would think the temporary lower capital gains rate and the dividends tax rate might be among those items in play. Of those two, the lower capital gains rate has enjoyed more bipartisan support in the past (and is probably of more interest to small businesses – unless we get tax reform and corporate rates go down and pass-through entities lose deductions and credits. Then dividends, by which C Corporations get their profits to their owners, becomes more important.)

One issue that was down for the count on the mat but has found new life as a result of the election is the current payroll tax holiday for employees that expires at the end of the year. Earlier this year, the Middle Class Tax Relief and Job Creation Act of 2012 (MCTRJCA) extended the temporary two-percentage point payroll tax "holiday" for employees (and to the same extent, to the self-employed) through the end of 2012. It would be quite a surprise for employees to have their first paychecks in 2013 shrink after a President pledging he is the protector of the middle class, is reelected by them. There is some talk of a different version of the relief being advanced, perhaps one based on a lowering of the tax rates below the $250,000 to product a similar result in the paycheck but without raiding the social security fund.

The fiscal cliff relief bill will probably address some of the perennial expiring tax relief provisions like the Research and Experimentation Credit. There are however a lot of credits and deductions among those extenders that appeal to the middle class. There is a laundry list of about 50 items and not all of them will make it into the package.

HEALTH CARE REFORM

If there is one certain outcome of the election, it is that health care reform will move forward towards its 2014 implementation. It is not a perfect path as there is the possible - a pending case that could make it back to the Supreme Court, a more probable – a fight over a technical glitch in the law regarding the establishment of a federal health care exchange for states that choose not to set up exchanges and the availability of premium assistance and the most probably – the House of Representatives producing appropriations bills that deny funding for aspects of the reform setting up appropriations battles with the Senate and President. (If I was the President, I might give some ground in the fiscal cliff relief package to win a fix for that exchange glitch.)

FILIBUSTER

The House majority remains the strongest defense against any anti-business legislative initiatives but the filibuster rule in the Senate, which requires 60 votes to end a filibuster, adds a level of comfort. With the Democratic Senate majority still in the low to mid 50's, it is still going to be tough to simply move new legislative initiatives in the Senate.

REGULATORY MACHINERY

We can expect a new round of regulatory developments, ranging from labor items at the National Labor Relations Board to Department of Labor health and safety rules to environmental regulations from the Environmental Protection Agency. Expect some battles in the Senate over confirmation of new appointees.

TAX REFORM

The big game in town in 2013 will be tax reform. Whatever is done to avert a plunge over the fiscal cliff, it will not settle all tax debates. Between pressure to reduce the federal deficit, the continuing strain of the Alternative Minimum Tax on a huge number of taxpayers, the strong cry for tax cuts for large corporations, the desire to get off the temporary tax relief treadmill, and the genuine need for a restart on simplifying and cleaning up the tax code, tax reform will be front and center. One thing about tax reform is no matter what they tell you, there are winners and losers. With the President protecting the middle class and consensus for corporate rate relief, pass-through entities such as sole proprietorships, partnerships, and S Corporations will find themselves occupying the same uncomfortable ground as high-income taxpayers. What trade-offs are made that affect those small pass-through entities is what will keep us up nights in 2013.

NEW TAXES

The election result does mean it is unlikely the new taxes that were embedded in the health care reform law will be reversed before they take effect on January 1st.

Hospital Insurance Trust Tax

As a revenue offset, the health care reform law increases the Medicare Hospital Insurance (HI) trust portion) of the payroll tax to 2.35 percent from 1.45 percent (i.e. a 0.9 increase) on wages or self-employment income over $200,000 for an individual return and $250,000 for a joint return on January 1, 2013. There is no limit on the amount of wages or self-employment income that is subject to the tax (unlike the social security portion of the FICA tax, which has a wage cap). This is an increase in the employee's share only. The employer will continue to pay to its 1.45 percent rate share on the employee's wages. In the case of the self-employed, they will pay "only" the additional 0.9 percent on the income above the $200,000/$250,000 threshold.

Unearned Income Medicare Contribution Tax

Since the HI applies only to earned income, the law establishes a new "Unearned Income Medicare Contribution" (UIMC) tax. This is calculated separately from the HI tax and would apply to "net investment income" which is interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and net gain from disposition of property (other than property held in a trade or business). The rate is 3.8 percent. The UIMC tax on net investment income would not apply if modified adjusted gross income is less than $250,000 in the case of a joint return, or $200,000 in the case of a single return. ***The UIMC tax takes effect in 2013.***

Other Changes

The threshold for claiming the itemized deduction for medical expenses is increasing from 7.5 percent to 10 percent, beginning in 2013.

Contributions to Flexible Spending Accounts (FSAs) are capped at $2,500 (indexed) annually, beginning in 2013.

ONLY THE BRAVE TREAD HERE

There is nothing risker than making the day after the election predictions particularly with respect to the fiscal cliff averted package. Whether the predictions are right or wrong, it is clear we have a lot of short term and long-term work in front of us to make sure small businesses remain the shining stars of our economy. Thank you for your support.