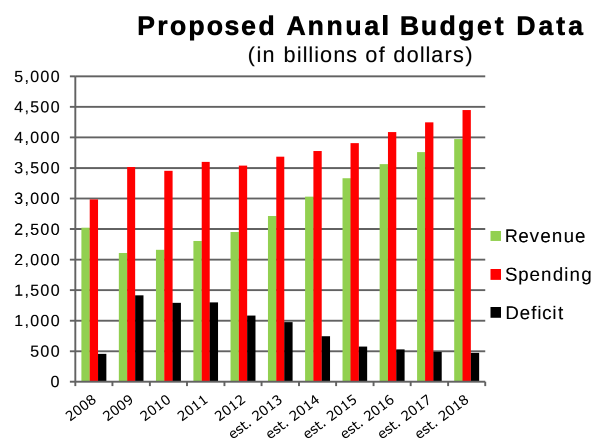
President Obama Releases 2014 Federal Budget Proposal

2014 proposal consistent with prior budgets, but enactment is uncertain

After more than two months of delays, President Obama recently released his fiscal year 2014 revenue proposals. The release of his budget proposal was held up because of the last minute negotiations that lead to the American Taxpayer Relief Act (ATRA) passed in January 2013, and while much of the content was repeated from his budget proposal of a year ago, there were some new items that caught the attention of individuals and businesses.

The President's Budget – By the Numbers

The President touted this budget as a balanced approach to reducing the nation's annual federal deficit and its growing national debt.



- The 2013 budget forecasts revenue of just over $2.7 trillion, up more than $260 billion from 2012. Spending is budgeted at nearly $3.7 trillion, an increase of about $150 billion from 2012.
- As a result, there is a projected deficit for 2013 of approximately $973 billion, down about 10% from the 2012 deficit.
- For 2014, the revenue and spending would be about $3.0 trillion and $3.8 trillion, respectively, leaving a deficit of $744 billion.
- Over the 10-year budget cycle, the cumulative deficit is projected to be $5.271 trillion. At no point during the 10-year cycle is the budget forecasted to balance.
- Combined with other lending, the total national debt would rise from $16.1 trillion at the end of 2012 to $25.4 at the end of 2023.

Comparison to House, Senate Budgets; Outlook for Passage

The US House of Representatives passed their version of a budget March 21. Their plan calls for a balanced budget by 2023, with deficits from 2014-2022 ranging from $54 to $125 billion. This would be achieved almost entirely through spending cuts, including a repeal of the health care act passed in 2010. The budget does propose substantial tax reform (a goal of moving to two individual tax rates of 10% and 25%, repealing the Alternative Minimum Tax, and lowering the corporate tax to 25%), but with no net change in tax revenue over what would be generated under the current tax policy. The budget did not include specific proposals on how to offset the reduction in tax rates and maintain the current tax revenue.

Two days later, the Senate also passed their own budget resolution. Their budget projects smaller deficits than the President's version in the early years, but larger ones in the later years of the 10-year cycle. The Senate proposal calls for $975 billion in both spending cuts and tax increases from 2014-2023, as compared to the current spending projections. The new taxes would come from "eliminating loopholes and cutting wasteful spending in the tax code". While the details for those increases were not specified in the budget, it does reference placing additional limitations on itemized deductions, changing the rules for depreciating corporate jets and increasing taxes on the income earned by hedge fund managers.

The following table summarizes the key budget items in all three proposals, as well as the baseline projections from the Congressional Budget Office:

Budget Item *	President Obama	House	Senate	CBO Baseline
2014 Revenue	$3,034	$3,003	$3,023	$3,003
2014 Expenses	$(3,778)	$(3,531)	$(3,715)	$(3,618)
2014 Deficit	$(744)	$(528)	$(692)	$(616)
Cumulative Deficit, 2014-2023	$(5,271)	$(1,225)	$(5,198)	$(6,958)
Debt held by Public at end of 2023 **	$19,030	$14,211	$18,229	$19,944

* All amounts in billions of dollars. ** Debt held by the public does not include debt held by other Government accounts and federal trust funds, such as the Social Security Trust Fund.

Given the significant differences in approach between the two houses of Congress (the Senate calls for $975 billion in tax increases, while the House projects no tax increases), it seems unlikely that a middle ground will be easily found. Because both proposals are relatively light on specific details, finding a starting point for negotiations will be difficult.

The President's proposal includes many of the same items that were part of his last few budgets, other than items that were included in the January 2013 tax act (higher tax rates on ordinary income and capital gains, return of the phaseout of deductions and exemptions, etc.). Those previous budgets had garnered little to no support from either side of the aisle, and both Republicans and Democrats used the term "dead on arrival" to describe this year's budget, albeit for different reasons. Republicans are contesting the tax increases proposals, while Democrats object to changes in the growth of Social Security benefits and other changes to entitlements. While his budget has no chance of being passed as-is, it does show where the President's priorities are when it comes to addressing the revenue and spending issues for the country, and aspects of this are likely to be included as part of future discussions on the debt ceiling and comprehensive tax reform.

The following are some of the key tax and related provisions included in the President's budget.

Reduce the Maximum Tax Benefit of Itemized Deductions

One of the primary components of this budget is one that has been debated repeatedly over the last few years – instituting a cap on the benefit of various tax deductions and preferences. This year's version is identical to what was proposed a year ago.

The Obama proposal would limit the tax benefit of itemized deductions to 28%. To illustrate how that would work, a taxpayer in today's top tax bracket would pay 39.6% tax on every additional $10,000 of income, or an additional tax of $3,960. However, under this proposal an additional $10,000 of itemized deductions for that same taxpayer would only provide a $2,800 tax benefit, a difference of $1,160. Taxpayers in the 28% bracket or lower would not be impacted by this proposal. As with last year, this recommendation expands beyond itemized deductions to include the following items (among others):

- Interest earned on tax-exempt state and local bonds
- Contributions to defined contribution retirement plans and IRAs
- Employer-sponsored health insurance, whether paid for by the employer or pre-tax by the employee
- Health insurance costs of self-employed individuals
- Contributions to health savings accounts and Archer MSAs
- Interest on student loans and higher education expenses

Example: A taxpayer in the proposed 39.6% tax bracket who earns interest on a municipal bond would pay a tax of 11.6% on that income (39.6% less 28%) in 2014.

Proposals of this nature were also a key point for both parties in the 2012 Presidential campaign, and the Senate budget also proposes some form of cap on these benefits. Given there seems to be general bipartisan agreement in this area, some limitation here seems likely to happen at some point. The differentiator will be what, if any, type of offset to this tax increase is agreed to.

Cap on Contributions to Retirement Plans

The item that has received the most attention since the budget was released is a proposed cap on the accrual of benefits within retirement plans. Under this proposal, once the total value of all an individual's tax-favored retirement plans (Traditional and Roth IRAs, 401(k)s, 403(b)s, etc.) is large enough to provide an annuity of $205,000 per year, no further contributions may be made to any of those accounts. The $205,000 is the same maximum benefit that is available under a qualified defined benefit plan (such as an employer pension plan) for 2013.

Each year, a calculation would be made to determine how much is necessary to purchase an annuity that would pay that $205,000 over the joint life expectancy of a taxpayer and their spouse. In the current interest rate environment, it's expected an annuity of that nature would require approximately $3.4 million. However, if interest rates were to rise – and rates are at historically low levels today – that value would fall. For example, it was estimated that in 2006, it would have taken just $2.2 million in retirement account balances to reach that limit.[1]

Once a taxpayer's cumulative retirement plan balances reach that level, the ban on further contributions would apply. The accounts may still continue to grow as a result of investment performance, but future

[1] Employee Benefit Research Institute, "The Impact of a Retirement Savings Account Cap", April 12, 2013, www.ebri.org

contributions will be treated as excess deferrals, potentially subject to a penalty. This proposal would apply beginning in 2014.

Changes to Distributions from Retirement Plans

Another proposal affecting retirement plans would prevent most non-spouse beneficiaries of retirement plans and IRAs from taking distributions from those plans over their remaining life expectancy. Instead, these beneficiaries would have to deplete those inherited retirement plan accounts by the end of the year containing the 5th anniversary of the owner's death.

This proposal would not apply to any beneficiary who is disabled, chronically ill or who is no more than ten years younger than the original account owner. It would also not apply to beneficiaries who are minors, although they would have to deplete the account within 5 years after reaching the age of majority. This proposal would apply to retirement plans or IRAs owned by anyone who dies after 2013.

Other proposed changes affecting retirement plan balances include:

- A proposal in this budget would exempt an individual from the RMD rules if the aggregate value of that individual's IRAs and retirement plan balances does not exceed $75,000 (adjusted for inflation). The RMD rules would be ratably phased in for aggregate plan balances between $75,000 and $85,000, and would be effective for those turning 70½ on or after December 31, 2013.
- Non-spouse beneficiaries of an IRA or employer retirement plan are currently only allowed to roll those assets into an inherited IRA via a trustee-to-trustee transfer. This proposal would allow those beneficiaries to also use the 60-day rollover provision, which currently is only available to spousal beneficiaries.
- Lastly, employers in operation for at least two years and having more than 10 employees would be required to offer an automatic IRA option to those employees funded through payroll deductions. Employees could opt out if they choose. A temporary tax credit – $500 in the first year, $250 in the second year, plus $25 per enrolled employee (up to $250) for the first six years – would help small employers offset the cost of this plan.

Implement a Tax to Meet the Buffett Rule

The President's prior-year budget made a passing reference to the Buffett Rule, but didn't include a specific proposal on how to implement it. This year, a new "Fair Share Tax" (FST) would move toward his goal of creating a minimum tax rate of 30% on high-income earners.

The tentative FST would be a tax equal to 30% of taxpayer's Adjusted Gross Income (AGI) over $1 million, less a 28% credit for itemized charitable deductions that exceed the overall limit on itemized deductions. The net of these two amounts is then compared to the total regular income tax (including AMT and the 3.8% Medicare tax on investment income, but less certain credits) and payroll taxes paid by an employee. The amount of actual FST paid would then be phased in as AGI rises from $1 million to $2 million.

Example: A married couple has AGI of $1.5 million and charitable contributions of $100,000, and their total regular, AMT and payroll taxes (before the FST) are $325,000. The FST is calculated as follows:

- The Tentative FST is 30% of AGI, or $450,000.
- At that AGI level, the phaseout of itemized deductions would be approximately $36,000. The charitable contribution credit would then be 28% of $64,000 ($100,000 less the $36,000 phaseout), for a net credit of about $18,000.
- The net of the tentative FST and the charitable credit is then $432,000.
- The FST owed would be $432,000 less the $325,000 in other taxes they would have paid, for a net of $107,000.
- Because their AGI is $1.5 million (less than the $2 million level where they would pay the full FST), the $107,000 is phased in on a pro rata basis, resulting in an additional tax of $53,500.

This tax would take effect beginning in 2014, and the AGI level for the phaseout would be indexed for inflation after that year.

Changes to How Indexing for Inflation is Calculated for Tax Provisions

The item that has created the most controversy within the President's own party is the proposed change to how certain tax provisions would be indexed for inflation. The impact on future Social Security benefits has received the most attention, but this proposal would affect all taxpayers by changing how many other tax-related items are calculated each year.

Inflation adjustments are currently made using the CPI for Urban Consumers (CPI-U), which measures price changes on a broad range of items bought by a typical consumer. This measure has been criticized as overstating the real purchasing trends of consumers by ignoring a form of "substitution bias". It misses the fact that consumers will not only replace a higher priced good with a lower priced good of similar style, but will even replace that good with an entirely different item. For example, consumers may replace high-priced ground round with less expensive ground chuck, but they may also replace it with chicken. CPI-U accounts for the change to ground chuck, but not the change to chicken. For that, economists developed chained CPI-U. The Congressional Budget Office has estimated that chained CPI-U will be about 0.25% lower annually, on average, than CPI-U.

Changing the indexing formula to use chained CPI-U would not only result in slower growth in Social Security benefits, it would also slow the growth many of the tax-related values that currently rely on CPI-U. As a result, taxpayers may find themselves in a higher marginal tax bracket over time, or with a smaller standard deduction or personal exemption. This change would take effect beginning in 2015.

Changes to the Estate Tax System

Included in the ATRA in January were changes to the estate tax system that permanently increased the exemption, indexed it for inflation, and also raised the tax rate on estates to 40%. Under the President's budget, that permanency would end after 2017.

Beginning in 2018, the estate tax exemption would fall from the $5.25 million we have today (plus future inflation adjustments) to $3.5 million. The gift tax system would be de-coupled from the estate tax once again, and the maximum exemption for gifts made during lifetime would be reduced to $1 million. No inflation adjustments would be allowed, and the top tax rate on gifts and estates would rise to 45%. The portability system introduced a few years ago, which allows for unused exemption amounts to be passed to a surviving spouse, would remain in place.

Other proposed changes to the estate tax system, most of which were included in previous budget proposals, include:

- Grantor Retained Annuity Trusts (GRATs) would be subject to a minimum term of 10 years, and the remainder interest at the time the trust is created must be greater than $0.
- The basis of property received as a result of death would be required to match the value of the property as reported for estate tax purposes. In addition, someone receiving a gift during a donor's life (instead of from the donor's estate) would have to use the same cost basis amount that the donor used. In practice, this has been done in most cases of property transfers, but the proposal would make these items law. The executor of the estate or the donor of a gift during lifetime would be required to provide this cost basis information to both the recipient and the IRS. This would be effective for transfers after enactment of the law.
- Distributions from a Health and Education Exclusion Trusts (HEETs) would no longer qualify for the gift tax exclusion that applies to educational and health care payments. That exclusion would only apply to payments made by a donor directly to a provider, not indirectly through a trust.

Other Changes Affecting Individual Taxpayers

The President's budget also includes several other provisions, many of which were included in prior budget proposals. Unless otherwise indicated, all these items would be effective in 2014.

- A partner's share of income from a "services partnership interest" (otherwise known as "carried interest" income) is currently taxed as a capital gain, rather than ordinary income. The President has again proposed taxing this income as ordinary income, as well as making the income subject to self-employment taxes.
- Require accrued market discount on a bond to be reported as income in the year of accrual, rather than allowing this to be optional as it is today.
- When selling shares of stock today, investors can choose which tax lot is being sold in order to manage the gain or loss they are recognizing. This budget would require the use of average cost basis for all identical shares of stock owned, even those owned in different accounts or at different locations, thereby limiting the flexibility available to taxpayers. The proposal would only apply to taxable accounts, as cost basis is immaterial in tax-preferred accounts, and would only apply to stock that is considered long-term and whose basis is required to be reported to the IRS upon sale (aka "covered securities").

- The Child & Dependent Care Credit would be expanded so fewer families are phased out. The maximum credit would begin decreasing once income reached $75,000 (up from $15,000), and reach the minimum credit level at $103,000 of income (up from $43,000).
- Any qualified principle residence debt that is forgiven through the end of 2015 would be excluded from income. The current exclusion expires after 2013.
- The tax on cigarettes would increase from just under $1.01 per pack to about $1.95 per pack.

Corporate Tax Changes

The Administration proposes adding, changing or extending a variety of provisions impacting corporate taxpayers. These changes are intended to reform the U.S. international tax system, eliminate tax preferences for oil and gas companies and improve overall tax compliance by businesses. Highlights of the corporate tax changes include:

- The R&E credit allows businesses to claim a tax credit equal to 20% of qualified research expenses. This credit is scheduled expired after 2013, but would be permanently extended in this proposal.
- The last-in, first-out (LIFO) method of inventory accounting would no longer be allowed in tax years beginning after December 31, 2013. Companies will be required to recognize taxable income related to revaluing its inventory, but can spread that income out over ten tax years.
- The Intangible Drilling Costs (IDC) deduction would be eliminated, and these costs would instead have to be capitalized and depreciated over time, beginning with costs incurred after 2013. The use of the percentage depletion method of recovering the capital cost of oil and gas wells would also be disallowed after 2013. Also, working interests in oil and gas entities would no longer be considered active, but would instead be subject to the passive loss rules beginning in 2014. This change would greatly limit investors' ability to deduct losses generated by these activities. In addition, several tax preferences provided for the exploration for and development of coal-related products would be eliminated.

Miscellaneous Budget Provisions

Beyond the income tax-related items in the President's budget, there are several other provisions that will impact individuals in their daily activities.

- Federal workers will be required to increase their contributions to retirement plans by 1.2% over three years beginning in 2014. The actual pension benefit would be unchanged.
- The Aviation Passenger Security Fee would be increased. The fee is currently $2.50 per flight segment, with a maximum one-way charge of $5. This would be replaced with a flat $5 fee for each one-way trip (including direct flights) in 2015, and would gradually increase to $7.50 by 2019.
- Retirees whose income exceeds certain thresholds are subject to higher premiums for Medicare part B and D coverage. Beginning in 2017, these higher premiums would be increased by 5%. In addition, beginning in 2017, new enrollees would see their deductible under Part B increase by $25 in 2017, 2019 and 2021, and would have a new $100 deductible added for home health care episodes.

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