Retirement Income
JOURNAL

Summary of proposals in Obama budget

By Editor Test *Tue, Feb 21, 2012*

Here are proposals in the new Obama budget that are likely to affect members of the financial, insurance or retirement planning industries.

Earlier this month, President Obama proposed his federal budget plan for fiscal year 2013, which rescinds the Bush-era tax cuts. A newly-released report from CCH, a Wolters Kluwer business, analyzes the proposals. In this article, *RIJ* republishes the proposals (with CCH commentary) affecting the financial, insurance, and retirement industries.

The analysis pointed out that the proposals hinge on this year's presidential election. "Most likely, the lame duck Congress that returns to work after the November elections will take up the fate of the Bush-era tax cuts," the analysis said. "The outcome of the November elections will also most likely determine whether many of the other items in President Obama's FY 2013 budget proposals will either fade into history or become strong contenders for tax legislation at the end of 2012 and into 2013.

"President Obama's FY 2013 budget is proposed in an environment unlike others in the recent past. The Budget Control Act of 2011 reduces the federal deficit by at least $2.1 trillion over the FY 2012 – FY 2021 period. Absent Congressional amendment, an automatic spending reduction process is scheduled to begin in January 2013. The automatic reduction would be divided evenly between defense and non-defense spending."

Below are some of the items in the summary that may interest *RIJ* readers:

RETIREMENT MEASURES

In February 2012, Treasury and the IRS issued a guidance package intended to encourage employers to offer more flexibility to workers in retirement savings vehicles. The administration launched a similar initiative in 2009. President Obama's FY 2013 budget reflects these developments.

Saver's Credit. The retirement savings contribution credit – also known as the saver's credit – is available to lower and moderate income taxpayers and offsets a portion of the first $2,000 individuals contribute to IRAs, 401(k)s and other retirement savings vehicles. President Obama has proposed to make the saver's credit refundable and make other modifications to encourage individuals to contribute to retirement funds.

COMMENT: *For 2012, the AGI limit for the saver's credit is $57,500 for married couples filing joint returns; $43,125 for heads of households; and $28,750 for married taxpayers filing separately and single taxpayers.*

FINANCIAL AND INSURANCE INDUSTRIES

President Obama has proposed a number of tax-related proposals affecting the financial and insurance industries.

Financial Crisis Responsibility Fee. The President would impose a fee on covered liabilities of U.S. bank holding companies, thrift holding companies, certain broker-dealers and insured depository institutions with assets in excess of $50 billion. The rate of the fee would be 17 basis points, discounted by 50 percent for more stable sources of funding, such as long-term liabilities.

IMPACT: *The fee would be effective beginning January 1, 2014 and is intended to re-coup the costs of the Troubled Asset Relief Program (TARP) and to discourage excessive risk-taking by major financial firms.*

Sale of Corporate Stock. A corporation does not recognize gain on the issuance or forward sale of its own stock, but does recognize interest income on a current sale of its stock for a deferred payment. The President's proposal would require the corporation to treat a portion of the payment from a forward sale of stock as a payment of interest, includible in income.

Dealers. Dealers of certain property (commodities, commodities derivatives, securities, and options) treat 60 percent of the income from day-to-day dealer activities as capital gains. President Obama would require these dealers to treat the income as ordinary, not capital. The proposal would apply to individuals and partnerships.

IMPACT: *Dealers of other types of property treat income from their day-to-day dealer activities as ordinary income. There is no reason for different treatment, according to the administration.*

Definition of "Control." If a corporation purchases a debt instrument convertible into its stock or into stock of a controlled or controlling corporation, the tax code limits the deduction for any premium paid to repurchase the instrument. The President's budget would expand the definition of "control" to encompass indirect relationships (a parent and a second-tier subsidiary) as well as direct relationships (a parent and its first-tier subsidiary). The proposal would be effective on the date of enactment.

Life Insurance. President Obama has proposed requiring a purchaser of a policy with a death benefit of at least $500,000 to report the purchase. The insurance company would have to report the payment of any policy benefits to the buyer. The proposal would also modify transfer-for-value rules to ensure that buyers are properly taxed when they collect on the policies.

IMPACT: *Recent years have seen a significant increase in transactions where individuals sell their previously-issued life insurance contracts to investors. The administration is concerned that investors are not reporting payments they receive, and may be inappropriately escaping taxes on the profit when the insured person dies.*

Proration Rules. Under current law, a life insurance company must prorate its investment income between the company's share and the share allocated to policyholders. The proration is used to limit the company's funding of (deductible) reserves with tax-advantaged income, such as dividends and tax-exempt interest. President Obama has proposed a simpler regime, a flat proration percentage of 15% that is applied to non-life insurance companies regarding the dividends-received deduction, tax-exempt interest, and certain policy cash values.

COLI. President Obama would expand the pro rata interest expense disallowance regime that applies to corporate-owned life insurance (COLI). The current disallowance regime is designed to prevent the deduction of interest expense that is allocable to a life-insurance policy's inside buildup that is not taxed. The proposal would eliminate an exception to the regime for contracts that cover the lives of officers, directors, and employees. The proposal would not repeal the exception for 20-percent owners.

IMPACT: *Retaining the exception for 20-percent owners would benefit small businesses and other taxpayers that depend heavily on the services of a 20-percent owner.*

IRS BUDGET

The IRS' budget was cut by $305 million for FY 2012. President Obama has proposed to increase the IRS' FY 2013 budget by $944.5 million (an 8% increase from FY 2012 levels). More than $400 million would be devoted to new enforcement activities, which the IRS projected would raise $1.48 billion in revenue annually at full performance, once newly hired employees are fully trained and develop broader experience by FY 2015.

COMMENT: *President Obama also proposed a multi-year program integrity cap adjustment for IRS tax enforcement to fund $350 million in new revenue-producing initiatives above current levels of enforcement and compliance activities.*

INDIVIDUALS

President Obama's FY 2013 budget proposals for individuals are a mix of old and new ideas.

Payroll Tax Cut. The Temporary Payroll Tax Cut Continuation Act of 2011 extended the employee-side payroll tax cut through the end of February 2012. President Obama's budget proposed to extend the employee-side payroll tax cut for all of calendar year 2012. Congress approved that extension on February 17, as part of the Middle Class Tax Relief and Job Creation Act of 2012. No proposal to extend this OASDI rate reduction for a third year, into 2013, has yet been made.

Income Tax Rates. As expected, the President would reinstate the 36% and 39.6% tax rate brackets for higher income taxpayers. When the tax rate brackets provided under Bush-era legislation and extended by the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (2010 Tax Relief Act) expire after 2012, the President would extend the tax rate brackets of 10, 15, 25, and 28 percent, eliminate the 33% and 35% tax rate brackets, and reinstate the prior law tax rate brackets of 36% percent and 39.6%. The rate increases, the President explained, would apply to single individuals with incomes over $200,000 and to married taxpayers filing joint returns with incomes over $250,000 levels. These income levels are 2009 amounts, indexed to inflation in subsequent years.

IMPACT: *After 2012, additional Medicare taxes impacting higher income taxpayers are scheduled to take effect. The Patient Protection and Affordable Care Act imposes both a 3.8% Medicare tax on the lesser of an individual's net investment income for the tax year or modified AGI in excess of $200,000 ($250,000 in the case of joint filers) as well as an additional 0.9% increase in the Hospital Insurance (HI) portion of the FICA tax for individuals falling into that same income range.*

Personal Exemption Phaseout/Limitation on Itemized Deductions. The Bush era tax cuts, as extended by the 2010 Tax Relief Act, gradually phased out and then removed–but only through 2012—two long-standing cutbacks in the amount of personal exemptions and certain itemized deductions otherwise taken by higher-income taxpayers.

Under these limitations, the deduction for personal exemptions of taxpayers and their dependents phased out for taxpayers with adjusted gross income in excess of certain thresholds. Additionally, the amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, theft and casualty losses, and wagering losses) were reduced by three percent of adjusted gross income in excess of certain threshold amounts but not by more than 80 percent. Starting in 2013, these limitations are scheduled to return to pre-2001 levels unless Congress acts.

The President has proposed to reinstate the personal exemption phase-out and the limitation on itemized deductions for single individuals with incomes over $200,000 and married taxpayers filing joint returns with incomes over $250,000, effective for tax years beginning after December 31, 2012.

COMMENT: *President Obama also has proposed to reduce the value to 28% of specified exclusions and deductions that would otherwise reduce taxable income in the 36% and 39.6% income tax rate brackets. A similar limitation would apply under the AMT.*

AMT. The President's budget envisions repeal of the AMT and its replacement with the so-called Buffett Rule (discussed below). Until (and if) repeal is accomplished, the President proposed to extend the AMT "patch." The patch provides increased exemption amounts.

IMPACT: *For 2011, the AMT exemption amounts were $48,450 for single individuals, $74,450 for married couples filing joint returns and surviving spouses, and $37,225 for married couples filing separate returns. Absent action by Congress, the AMT exemption amounts for 2012 are $33,750 for single individuals, $45,000 for married couples filing joint returns and surviving spouses, and $22,500 for married couples filing separate returns. Most everyone in Congress agrees that the AMT needs to be fixed, but a permanent solution has been avoided so far because of the significant offsetting revenues that would be needed. One possible scenario is for another one-year AMT "patch" to be enacted for 2012, followed by rolling a solution* *into an overall consideration of comprehensive tax reform for years after 2012.*

Buffett Rule. The President's FY 2013 budget does not include a specific Buffett Rule but keeps it alive as a future goal. President Obama has asked Congress to pass measures that ensure individuals making over $1 million a year pay a minimum effective tax rate of at least 30%.

COMMENT: *President Obama first proposed the Buffett Rule in 2011 and repeated the proposal in his 2012 State of the Union address. Sen. Sheldon Whitehouse, D-RI, has introduced legislation based on the President's proposals. Taxpayers earning over $2 million would be subject to a 30% minimum federal tax rate. The tax would be phased in for incomes between $1 million and $2 million, with those taxpayers paying a portion of the extra tax required to get them to a 30% effective tax rate.*

Capital Gains/Dividends. Under the President's proposal, reduced tax rates on qualified capital gains and dividends enacted during the Bush-era and extended by the 2010 Tax Relief Act would expire after 2012 for higher income taxpayers.

The President would increase the tax rate on qualified capital gains to 20% for single individuals with incomes over $200,000 and married taxpayers filing a joint return with incomes over $250,000, effective for tax years beginning after December 31, 2012.

In a controversial move, however, the President proposes that the current reduced capital gain tax rates on dividends would expire at the end of 2012 for those taxpayers above the $200,000/$250,000 level and would be replaced by taxing them as ordinary income.

IMPACT: *Decoupling capital gains and dividends caught many administration observers by surprise. The tax rates on qualified capital gains and qualified dividends have been linked for nearly 10 years. A Treasury official told reporters that "long-term capital gains often have had a preferential rate for the entire history of the income tax from 1913 until now." Utility companies and other industries that traditionally rely on rewarding investors through regular dividends rather than dramatic share appreciation are obviously expressing concern over this proposal. A decoupling of capital gains and dividends would also resurrect certain universal techniques and issues inherent in corporate tax planning for taxable distributions.*