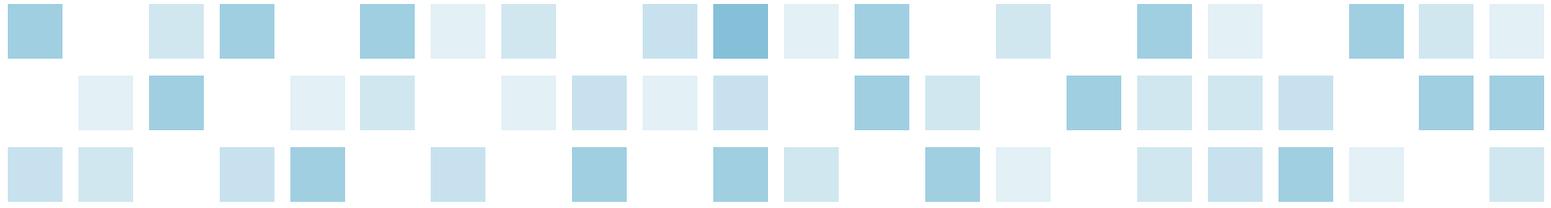


Year-end Capitol Hill update for the middle market



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Overview

With the recent passage of a bipartisan, two-year budget agreement, it may be time to take a look back at important developments in Washington during 2013 and what they may portend.

- For middle market companies and their owners, 2013 began with (1) major structural changes to the individual and estate tax rules, (2) repeated calls for fundamental tax reform, including questions about the future of pass-through entities, uncertainties about a new tax on net investment income, and (3) huge uncertainties about the potential cost of complying with the Affordable Care Act.
- The year ended with a major two-year budget agreement, suggesting there will likely be no standoffs between the Democrats and Republicans on overall levels of spending or taxes. This likely means that the “permanent” tax rates enacted at the beginning of the year will remain unchanged for the foreseeable future and that fundamental tax reform, with its unique risks for the middle market, will be on the back burner at least until after the 2014 election, and possibly longer. The federal debt ceiling must be extended, perhaps several times over the next year or two, but it seems unlikely at this point that major tax hikes or significant spending cuts will be added to such legislation. The president and the Democrats are largely against adding any provisions to a debt-ceiling extension, and the Republicans are against revisiting taxes, even so-called loophole closers, outside of comprehensive tax reform.
- Even with the addition of the 3.8 percent tax on net investment income, the effective tax rate on middle-market owners of businesses taxed as proprietorships or pass-through entities will continue to be lower than the combined corporate and shareholder rates imposed on the earnings of C corporations. However, taxpayers structured as pass-through entities should remain vigilant, as there are some who advocate lowering the tax burden on C corporations, in part at the expense of owners of businesses taxed as pass-through entities.
- The dramatic effects of the Affordable Care Act on the individual and small group market (less than 50 full-time employees or equivalents) will continue to be in the headlines as a political topic, if not the subject of any actual legislation. At the same time, changes to the large group market may be less dramatic.

- Most large employers (50 or more full-time employees or equivalents) are already providing most of their full-time employees with health care coverage comparable to that required by the new law. A combination of new Affordable Care Act fees, taxes, and plan design mandates will certainly affect overall costs. However, as large employers review their options under the Affordable Care Act—with the “play-or-pay” decision delayed until 2015—it is anticipated that most will find it does not make economic sense to drop existing employer-provided health plans. While some employer costs will increase, many employers are already providing greater health care subsidies to their workforce than the law requires. Thus, these employers potentially have room to pass on to their employees some of the new costs. Overall, either bearing the additional costs or passing them on to employees will make more sense for many employers than dropping coverage, paying penalty taxes, and, in some cases, increasing cash wages to make up for the change to the overall benefit package. Naturally, if an employer does choose to increase the amount that employees must pay for their health care, employees may perceive this as a negative, even if they also benefit from certain enhancements in coverage.

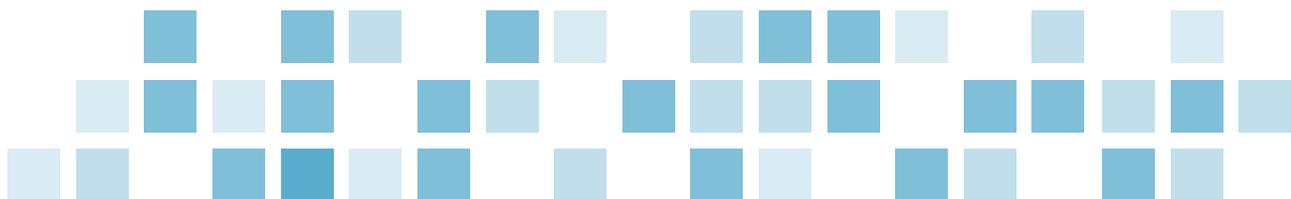
2013 in review: Tax rates get “permanent”

2013 was a crucial year for federal tax rates affecting the middle market. Though no tax law or tax rate is truly permanent since a future Congress can always change the law, for the first time in many years, the most important federal tax rates do not have expiration or “sell-by” dates. They are fixed in the law, unless Congress changes them. In addition, the most widely used tax brackets, exemptions, standard deductions and exclusions are indexed for inflation. With the absence of any scheduled expiration dates or tax-bracket creep, there will be no need to revisit the basic tax structure unless a consensus exists to either raise revenue, which is unlikely if the Republicans retain control of the House, or “reform” the tax code without raising revenue (e.g., by lowering rates and paring back deductions or exclusions), which is unlikely if the Democrats retain control of the Senate.

Where does that leave us?

- Many middle-market businesses are taxed under the individual tax rate schedules. Unless Congress and the president act to the contrary, the top tax rate on individual income will remain at 39.6 percent, the top tax rate on individual capital gains will remain at 20 percent, and there will remain a 3.8 percent add-on tax on individual investment and business income in some cases. The impact of these tax increases is greater than it might appear because individuals also face a reduction in personal exemptions and allowable deductions, which tend to decrease taxable income. Thus, greater amounts of income are subject to tax.
- Some middle-market businesses are taxed as C corporations, which continue to be subject to a 35 percent corporate rate. When combined with an individual tax on corporate dividend distributions (or capital gains from the sale of shares), the overall rate still exceeds the rate imposed on owners of non-corporate businesses. (This will also be true after taking into account the 3.8 percent tax on net investment income.)
- The unified estate and tax exclusion for married couples is approximately \$10 million (or the equivalent in inflation-adjusted dollars) with a top rate of only 40 percent applied to any excess.

The Jan. 1, 2013, expiration date for the Bush-era tax cuts represented the major impetus for adopting these new non-expiring rules in early 2013. Jan. 1, 2013, was also the effective date of the 3.8 percent add-on tax on net investment income, which was enacted in 2010 to help pay for the Affordable Care Act.



The combined effect of these changes for a hypothetical married couple with taxable income of around \$1 million was an annual income tax hike in the neighborhood of \$36,000 to \$66,000—depending on the extent to which they were subject to the 3.8 percent add-on tax on net investment income. Because income tax rates and brackets are indexed for inflation, it is possible to project that these tax increases, over a 30-year period of peak earnings, would exact an increased lifetime tax burden on this hypothetical couple of approximately \$1.5 million in today's dollars.

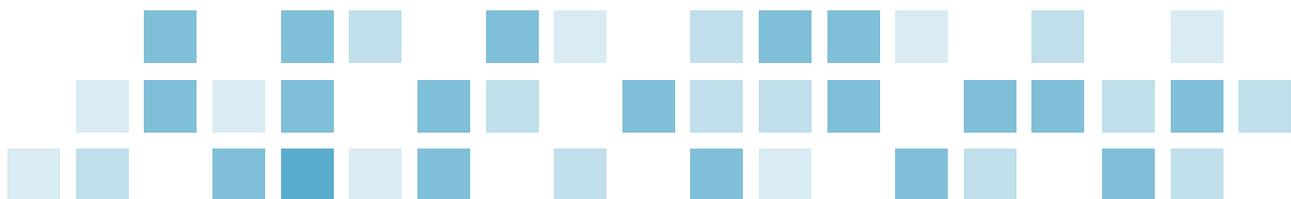
The good news, for high-income professionals or business owners in that economic bracket, is that the Bush-era cuts to the estate, gift and generation-skipping transfer taxes were essentially made permanent and indexed for inflation. For many families owning middle-market businesses, those savings will be worth far more than \$1.5 million when compared to the Clinton-era estate and gift tax rates that would otherwise have applied. If our hypothetical million-dollar-a-year couple could save and invest enough to leave at least a \$10 million estate (in 2013 dollars), they would save around \$4.5 million in estate taxes that would otherwise have been due under the Clinton-era tax rates.

In effect, even for higher-income taxpayers, only around 25 percent of the Bush-era tax cuts (the income tax cuts) were repealed, while close to 75 percent (the estate tax cuts) were preserved and made “permanent.” It is unlikely that Congress will revisit these estate and gift tax changes. The failure of the prior unified exclusion to keep up with inflation was the major reason estate and gift taxes were such a recurrent problem for Congress in the last 20 years. Now that these amounts are indexed for inflation, estate and gift tax rates and exclusions are unlikely to be revisited. In addition, while addressing estate and gift taxes may create some political capital, in truth, these taxes represent a tiny fraction of overall tax revenues. Though the Obama administration did propose in early 2013 to cut back some of these benefits, the revenue that would have been raised was almost inconsequential. Thus, it would appear these rates are not going to change in the short term, despite the strong emotions arguments about inherited wealth tend to generate on all sides.

Notably, despite a 2012 proposal of the Obama administration to raise top corporate dividend rates to as much as 43.4 percent, the corporate dividend tax rate was “permanently” equalized with the general rate on long-term capital gains. The combined top tax rate on corporate income, taking into account both the 35 percent corporate tax and a top individual tax rate of 23.8 percent on corporate dividends, is now 50.47 percent, compared to a top individual tax rate on business income earned from proprietorships, partnerships or S corporations of 43.4 percent. The top rate for non-corporate businesses is only 39.6 percent if the income is earned from an entity in which the taxpayer is a material participant, and only 20 percent if the income represents capital gains from the sale of such a business. Middle-market business owners, many of whom operate through pass-through entities, should continue to watch for proposed “tax reforms” that might seek to narrow this gap, almost certainly not to their benefit.

If, as anticipated, no further rate changes occur during the remaining years of the Obama administration, the overall tax hit from that administration may not be as burdensome as much of the rhetoric about taxes and business over the last few years might have suggested.

- The pre-Obama-era status quo of taxes on those with high enough incomes to leave an estate of \$10 million or more was more than half preserved, even after taking into account income tax hikes.
- No “Buffett rule,” similar increase to the individual minimum tax, or attack on capital gains or “carried interest” has been enacted. Indeed, as mentioned above, the capital gains rate was extended to corporate dividends.



- The pre-Obama-era status quo for those making under \$250,000 was also largely preserved.
- Perhaps the biggest losers were upper-middle income earners making somewhat more than \$250,000 but not making enough to take advantage during their lifetimes of the now permanent estate tax exclusion of \$10 million per couple.
- Other potential big losers will be those making more than \$100,000 who are ineligible for tax subsidies under the Affordable Care Act—if they experience substantial penalties or increases to their deductibles or premiums under that act.

Whither tax rates in 2014?

Despite the major changes enacted in early 2013, ostensibly “permanently,” over the last year the possibility that Congress could always change its mind made periodic extensions of the debt ceiling and continuing resolutions a dangerous exercise, with one side calling for even more tax increases and the other calling for reduced spending. Now that a two-year budget agreement has been approved, the likelihood of major new tax hikes before 2017 seems small.

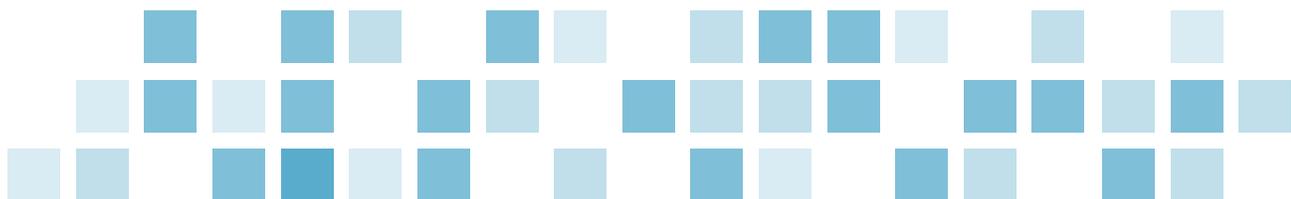
Exceptions to that prediction would be if (1) there is an unanticipated economic or bond-market emergency requiring a “grand bargain” or other bipartisan solution to the troubling problem of the growing national debt, (2) contrary to most current expectations, the president’s party takes control of the House of Representatives and retains control of the Senate, or (3) there is a continuing weakness in the sign-up for the Affordable Care Act, perhaps requiring federal financial assistance to the insurance industry.

The federal debt ceiling must be extended, perhaps several times over the next year or two, but it seems unlikely at this point that major tax hikes or significant spending cuts will be added to such legislation. The president and the Democrats are largely against adding any provisions to a debt ceiling extension, and the Republicans are against revisiting taxes, even so-called loophole closers, outside of comprehensive tax reform. Perhaps the one avenue that could lead to a major revision would be if Democrats indicated a willingness to address curtailing entitlement spending in exchange for Republicans making further concessions to the sequester.

Looking forward in 2014: Whither health care?

The major difficulties facing the individual insurance markets—cancelation of many existing policies, cost increases for some that are not offset by subsidies, and general website difficulties, likely will not be duplicated in the large group or large employer markets. Many employers will find they already offer or provide insurance with greater benefits, or at least at greater employer cost, than is required by the Affordable Care Act. These employers may actually find cost-saving opportunities under the act if they reduce their subsidies for workers to the minimum required under the law. This “cost savings” to an employer is a cost increase (much like a new tax) on the employee.

There is no evident cure in sight to the problem of part-time workers being exempted from the large-employer mandate, which is a problem for workers seeking full-time positions who may be required to work 29 hours or less to reduce the employer’s cost of providing them with insurance. It could be prohibitively expensive for Congress to change the definition of “part-time” from 30 hours to 40 hours, for example, because so many more workers would likely have their hours reduced from 40 to 39, which could make many more eligible for tax subsidies and thus drive up budgetary costs.



No visibility exists as to what ideas may be proposed to address the concerns of individuals who lose their existing insurance policies, are required to pay higher premiums or out-of-pocket expenses, or lose access to their preferred health care providers. One hopes, of course, that those problems will be minimized or mitigated.

It is worth noting that one of the major Republican alternative health care reform proposals—advanced by Senator John McCain in the 2008 Presidential Campaign but sharply criticized by then Senator Obama—might interact with fundamental tax reform. McCain’s proposal was to replace the exclusion of employer-provided health insurance premiums, which provides much greater benefit to higher-income individuals than to lower-income individuals, with a refundable tax credit of about \$5,000 per family to use on health insurance. For example, if one assumes a typical insurance cost of \$25,000 for an upper-income family, the existing deduction could be worth \$10,000, while the credit would be worth only \$5,000. Conversely, a lower-income family might find the exclusion worthless because they lack the cash to pay their share of the employer’s premium. For such a family, a refundable \$5,000 tax credit might be preferable to the benefits of the Affordable Care Act.

Interestingly, this approach of converting a tax exclusion or deduction to a flat credit, or otherwise limiting the value of a deduction to a flat 28 percent tax rate, has also been floated by the Obama administration for consideration in connection with deductions like those for mortgage interest, state and local taxes, and charitable donations. Owners of middle-market businesses and their more highly compensated employees are significant users of these deductions—yet another way in which that group may be a target of would-be tax reformers.

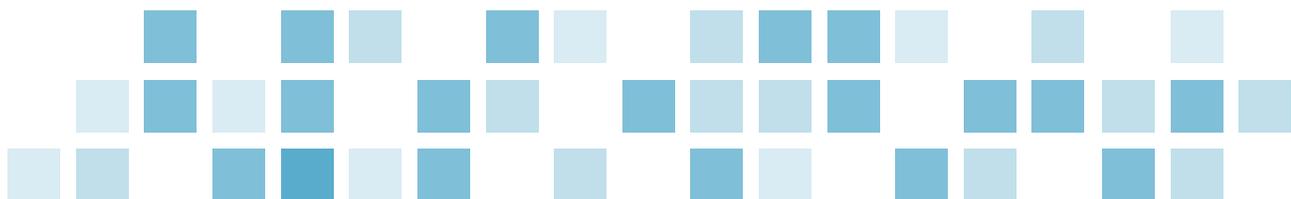
Looking forward in 2014: Whither tax reform?

The real question for tax reform is whether anyone expects it to accomplish anything of any substantial interest to the public—and, therefore, whether it is worth upsetting the many individuals and interests that will inevitably be “losers.” In theory, if Republicans gain control of both the House and Senate after 2014, they could pass revenue-neutral tax reform that lowers rates and pays for that with reduced tax preferences. The question is whether there would be many more “winners” than “losers” from such a plan.

No proposal under active consideration appears to do anything for the simplification of the income tax system, tax preparation, or tax compliance. Furthermore, it is questionable whether there are any simplification options available, even theoretically, for a system that taxes “income”—an inherently complex phenomenon.

There has been much discussion of lowering corporate tax rates on the grounds that they are high compared to the rates imposed by other countries. However, the only way suggested thus far to pay for such a change is the elimination of virtually all forms of accelerated cost recovery, which are very dear to those industries that utilize them (including many middle-market companies operating in pass-through form), and, perhaps, to eliminate the existing exclusion for income of U.S. companies earned abroad. Those are the major “tax preferences” used by corporations.

But, there is hardly a consensus on the treatment of foreign earnings. While the treatment of foreign earnings is a major item on the official list of corporate tax preferences, one side wants to expand the preference by more fully and completely exempting the foreign business income of U.S.-owned foreign corporations from tax. Conversely, many on the other side of the aisle strongly oppose our existing system of providing a quasi-exemption for such earnings on the grounds that it provides tax incentives for U.S. companies to move operations, and jobs, overseas.



Middle-market companies should be particularly concerned about the risk that corporate rate reductions might be “paid for” with cutbacks to cost recovery deductions or other preferences used by pass-through owners or with more far-reaching proposals to make more pass-through entities subject to the corporate income tax. If such a scenario occurs, middle-market taxpayers may not receive the rate reduction given to C corporations but very well may lose the deductions that were reduced or eliminated to pay for the corporate rate decrease.

However, unlike in 1986 when Congress was able to pay for major individual rate reductions with the elimination of individual tax shelters widely perceived as wasteful and inefficient, there is no general consensus on what tax reform means, even directionally. Though “major tax change” has become a mantra, there is no consensus as to the direction any such changes should take.

- Should foreign source active business income be taxed more heavily or more lightly?
- Should tax incentives for U.S. manufacturing be reduced (to pay for lower rates generally), expanded to promote job creation, or merely changed from deductions to a lower rate?
- More generally, should the tax code be used to advance industrial policies, such as the promotion of environmentally friendly fuels or technologies, or not be so used? Alternatively, is the only issue whether we have identified the precise lines of business or technologies deserving of a federal tax subsidy?

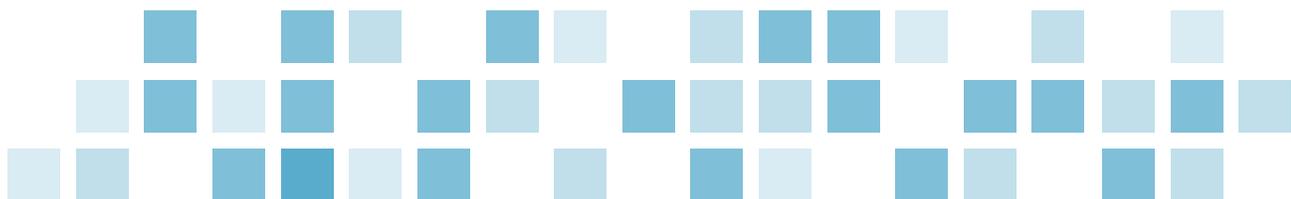
To use a railroad analogy often used to describe legislation, there are many passenger cars with the seats facing in different directions, but no apparent locomotive to drive the train in any direction.

In addition, it is not clear who the leaders of any tax reform initiative might be. President Obama, who is in his final term, does not appear to be strongly motivated in the area of tax reform. More importantly, President Obama recently announced that Senator Max Baucus, Chairman of the Senate Finance Committee and a strong proponent of fundamental tax reform, will be nominated to serve as our Ambassador to China, and thus will likely leave the Senate early in 2014. Before that announcement, some thought Senator Baucus’ previously announced retirement as of the end of 2015 together with the 2015 scheduled end of Congressman Dave Camp’s chairmanship of the House Ways and Means Committee were factors indicating that the two chairmen would drive the effort to consider tax reform in 2014 or 2015, before their terms expired. Now, only Chairman Camp remains as a strong proponent of tax reform who is facing such a deadline.

Whither entitlements in 2014?

With the recent changes to the sequester incorporated into the two-year budget agreement, there is again increased awareness that the real budgetary problems on the spending side relate to entitlements (and mostly Medicare and Medicaid). Though many hoped health care reform might curb health care expenses, the Affordable Care Act evidently focused more on insurance accessibility than on reducing gross health care costs, Medicaid was actually expanded, and the purported cost savings in the Medicare program that are contained in the law remain controversial.

Neither side, however, seems likely to bring up the topic of entitlement spending. Many leading Democrats are strongly against any changes to the entitlement programs, and Republicans are unlikely to want to “change the subject” from the Affordable Care Act.



Whither extenders in 2014?

Little visibility exists as to the when or whether, before the 2014 mid-term election, Congress may consider extending the various “expired provisions” that expired as of the end of 2013. In the past, Congress has been able to extend such provisions retroactively, and that clearly will be required again if they are to be extended in 2014. This absence of a real deadline for extension makes predictions even more difficult.

Expired provisions of note for many middle-market companies include:

- Section 41 research and development tax credit
- 50 percent bonus depreciation
- Section 179 expense limit drop from \$500,000 to \$25,000
- Section 179D energy efficient commercial building deduction
- 15-year depreciation for qualified leasehold improvements, qualified retail improvements and qualified restaurant buildings and improvements
- Work opportunity tax credit
- Section 45 renewable electricity production tax credit
- New markets tax credit
- Section 45L new energy-efficient homes credit
- Incentives for alternative fuels and alternative fuel mixtures
- Incentives for biodiesel and renewable diesel
- Subpart F exception for active financing income
- Subpart F look-through rules

Conclusion

McGladrey’s Washington National Tax office will continue to monitor developments in all of these areas. Although no major changes in the laws or rules affecting middle-market businesses and their owners are currently anticipated, things can “change on a dime” in the nation’s Capitol and taxpayers should consult with their tax advisors to stay informed as the year progresses.

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