Someone's Taxes Are Going Up – Could You Be A "Pay For?"

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Paying As It Goes – Congressional PAYGO

The first step Congress takes when changing tax policies for the U.S. Government is the adoption of a budget resolution. The annual budget resolution sets targets, limits, and assumptions that guide and govern Congress during tax policy debates. The budget not only provides dollar limits for any tax policy changes that Congress may consider, but can also include rules which limit certain Congressional activities for the span of the budget. One such rule, known as "PAYGO," helps prevent budget deficits by requiring members of Congress to "pay-as-they-go" for any spending or tax changes they make. For the last several years, Congress has not included strong PAYGO rules in its budget resolutions, but the newly empowered Democratic Congress has reinstituted these deficit fighting rules in its recent budget blueprint.

Under PAYGO, any provision which increases "direct spending" or reduces tax revenues must have an offsetting tax increase or spending cut to avoid a budget point of order. PAYGO points of order can only be waived by vote of three-fifths of the Members "duly chosen and sworn." With both House and Senate Democratic leaders vowing to maintain strict forms of the deficit fighting PAYGO rules, someone's tax burden is guaranteed to rise.

"Pay-fors"

Under a PAYGO regime, whenever a member of Congress seeks changes that increase entitlement spending or reduce revenues, he or she must find a "pay for." A "pay for" is a revenue raising provision which roughly offsets the cost of the policy change sought. While it is impossible to know exactly where a member of Congress will turn to find a revenue raising "pay for," there are certain patterns and sources that have emerged over the years. To find "pay fors" Congressional staff will scour official government proposals and resources to find policy ideas and reform measures that bring revenue into the government. Proposals from these sources that curb abuse or fraud are usually used quickly and, because they are less controversial, they are sometimes used several times (i.e. placed on several bills under consideration) to "pay for" policy changes until they are finally enacted.

When members of Congress and their staffs no longer have a non-controversial source of revenue raisers, they have to use political power and creativity to "pay for" their priorities. One of the first places members and their staffs will search for ideas is the headlines. Politicians are far more likely to craft revenue raisers tailored to hit taxpayers or industries who are in a defensive position publicly. Sometimes a "pay for" will be designed to raise taxes on a constituency or region that is unpopular or competing with the members voters. Often, members of Congress will turn to lobbyists willing to provide ideas that raise taxes on the competitors of their clients.

The taxpayers most vulnerable to specifically targeted revenue-raisers are the unsympathetic. Companies who have had bad headlines, committed bad acts, or are generally engaged in some sort of negatively perceived activity are always on the short list for tax hikes. Included in this unfortunate group are taxpayers benefiting from perceived windfalls or advantages. If a member of Congress wouldn't mind saying he or she raised taxes on "so and so company," that company should be concerned. In the current environment, taxpayers who are benefiting from increasing drug and health care costs, the war in Iraq, Hurricane Katrina relief, or tax avoidance planning are being scrutinized.

The next most vulnerable taxpayers are the disengaged. Thousands of documents and ideas will be considered by Congress as its members search for revenues. If no opposition is heard to a proposal, it can quickly make its way onto a piece of legislation. Corporate citizens run a particular risk of being targeted if they stay on the sidelines during times like these. In order to protect their interests and the interests of their clients, many lobbyists will help Congressional staff craft sophisticated revenue-raisers targeting other taxpayers. Often very technical, these provisions can fly below the radar and become law before unsuspecting companies or the media understand their scope.

PAYGO "Pay-fors"… Coming To A Taxpayer Near You

Looming in the very near future are several legislative matters which will force lawmakers to craft and pass revenue raising provisions. Congressional staff members are scrambling to find and craft new "pay fors" for emerging Congressional priorities.

The major tax cuts passed using the reconciliation process in 2001 and 2003 are set to expire or "sunset". For the last several years, Republican lawmakers have used a deficit reduction process known as "reconciliation" to pass tax cuts while avoiding a Senate filibuster. A resulting frustration is the requirement that any bill passed using the reconciliation process must "sunset" at the end of the budget window. With a 2010 sunset approaching for the 2001 and 2003 tax cut bills, the Congress has the option of extending those tax cuts, letting them expire, or crafting some combination of the two. Should Congress choose to extend any portion of those tax cuts, they will now have to be offset under a strict PAYGO requirement.

While the new Democratic majority may not be in a hurry to extend the capital gains tax cuts in the 2003 tax bill, they are not inclined to let items such as increased refundability for the Child Tax Credit, the decrease in individual marginal income tax rates for middle income families, adoption incentives, EITC changes, and various other Democratic priorities disappear. Democrats will also be under pressure to eliminate political opportunities which will be created for Republicans by the sunsetting 2001 and 2003 bills. For example, it is unlikely that the current estate tax law will not be changed by 2010. Currently, the estate tax is set to be repealed for one year in 2010 and be revived to its pre-2001 status in 2011. Most Democrats aren't interested in extending full repeal of the estate tax, and are even less interested in having exemptions so low and rates so high as to create a new political opportunity for the Republicans. Extension of any part of the 2001 and 2003 tax cut bills will require offsetting revenue-raising provisions.

There are several regularly-extended tax provisions that expire independent of a reconciliation rule. Extending these provisions will now require dollar-for-dollar offsets. A Joint Committee on Taxation publication lists 42 tax provisions set to expire in 2007, 19 in 2008, and 12 in 2009. Several provisions set to expire in 2006 were extended for just one year. These expiring provisions are generally considered "must pass" and include such things as the Research and Experimentation Tax Credit, the Work Opportunity Tax Credit, incentives for renewable fuels, and various other business-friendly sections of the Internal Revenue Code. Continued extension of these expiring provisions will now require revenue-raising offsets.

Reforming the Alternative Minimum Tax has emerged as a major tax priority of the new Democratic majorities. Originally designed to limit tax sheltering by very high income individuals, the AMT is increasingly impacting a greater percentage of taxpayers because its thresholds were never pegged to increase with inflation. Millions of relatively middle class taxpayers in states with higher incomes such as Democrat-laden California, New York, Illinois, and New Jersey are finding themselves subject to significantly higher taxes due to the AMT. While Congress has consistently passed annual extensions of AMT tax relief, the new Democratic leadership is now calling for a permanent fix of the AMT. Repealing the AMT would cost over $870 billion over the next decade. Even the most minimal reform ideas would cost over $95 billion over that time period. Although it is possible that AMT relief could be popular enough to achieve a waiver of a budget point-of-order, the current budget plan demands that any AMT relief be offset by "pay fors" from other taxpayers.

Finally, there are increasing demands on Congress to enact "enhancements" in mandatory spending programs. These changes will be expensive and must be paid for under the PAYGO budget regime. For example, there are forty-seven million uninsured Americans including nine million children. Members of Congress who ran on the issue of the uninsured feel that they have a mandate from the voters to address the issue which could cost several hundred billion dollars. Further, the highly successful "S-CHIP" program, which helps states provide health coverage for children whose families are too poor for private health coverage but are ineligible for Medicaid, is due for reauthorization. A certain battle over health care, insurance, and must-be-paid-for increases in entitlement spending means Congressional staffers are searching for new ways to bring revenues into Washington. The budget which passed the Senate includes a $50 billion increase in S-CHIP funding which is to be offset by $15 billion in unspecified Medicare cost reductions, and $35 billion in a "deficit-neutral reserve fund." That means "unspecified revenue raisers."

What Does It All Mean?

Committed to budget neutrality and their own priorities, Congressional Democrats have re-implemented the PAYGO regime. There is no doubt that, in order to offset the cost of their legislative initiatives, members of Congress will create new taxes and allow existing tax benefits to expire. Billions of dollars could change hands even though there may not be any major "tax" bills considered. While some taxpayers may see their tax bills stay the same or even go down, someone's taxes will be going up. Early warning, an effective government relations program, and experienced advice are the best protection in such an atmosphere. The last thing you want to become is a "pay for."

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Examples of "Pay-Fors"

From the Budget Committee's Compendium of "Tax Expenditures"

Elimination of Section 195 amortization of business start-up costs – **$3.9 billion over 5 years**

Elimination of the reduced rates on the first $10,000,000 of corporate taxable income – **$21.5 billion over 5 years**

Eliminate Section 163 Exemption for Imputed Interest – $2.1 billion over 5 years

Elimination of (or adjustments to) the Exclusion of Insurance Income on Life Insurance and Annuity Contracts – **$119.38 billion over 5 years**

Elimination of (or adjustments to) the Deduction of Unpaid Property Loss Reserves for P and C Insurance Companies – **$17.5 billion over 5 years**

Elimination of (or adjustment to) Deduction for Charitable Contributions to Educational Institutions – **$28.76 billion over 5 years**

Elimination of the Tax Credit for the Production of Energy-Efficient Appliances – **$0.2 billion over 2 years**

Elimination of Deferral for Active Income of Controlled Foreign Corporations – **$30.1 billion over 5 years**

From The President's FY08 Budget Proposal

Limit Related-Party Interest Deductions **– $998 million over 5 years**

Repeal Temporary 15-year Recovery Period for Natural Gas Distribution Lines – **$308 million over 5 years**

Require information reporting on merchant payment card reimbursements – **$3.33 billion over 5 years**

From the Joint Committee on Taxation's "Options to Improve Tax Compliance and Reform Tax Expenditures"

(with over 420 pages describing tax reform and tax expenditure modifications)

Provide that payments in redemption of stock held by an ESOP not deductible as dividends – **$3.4 billion over 10 years**

Modify safe harbor for allocation of nonrecourse deductions and exclude nonrecourse liabilities from outside basis – **$2.2 billion over 10 years**

Impose loan and redemption requirements on pooled financing bonds – **$100 million per year**

Curtail the use of lapsing trust powers to inflate the gift tax annual exclusion amount (Crummey Trusts) – **$100 million annually**

Others

Disallowance of ordinary deductible expenses for executive compensation costs not approved by shareholders – ***Revenue Estimate Not Available***

Windfall Profits Tax for Certain Revenues Derived From Certain Disaster Relief and Defense Department Contracts – ***Revenue Estimate Not Available***

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