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How the debt ceiling debate may affect your taxes

On Aug. 2, 2011, President Obama signed the Budget Control Act of 2011 (the Act) to increase the debt limit and avoid a potentially catastrophic default. While the Act contained no tax provisions, it created a new bipartisan joint committee responsible for identifying an additional $1.5 trillion in deficit reduction measures, which under the new law must be voted on in Congress by the end of the year. The members of this committee are expected to be named within the next few weeks. The committee's specific agenda has not been set, but we expect there to be significant debate about major changes to the tax code.

Given the relatively short time frame within which the committee has to work, it is likely that they will not be starting from scratch – rather we believe they will look to various revenue raisers that have been identified over the past few years.

Recently, the Obama administration, the Senate "Gang of Six," the White House's deficit commission, and others have all floated proposals for minor tweaks and/or major changes to the tax laws. The following list summarizes the range of some of the tax changes that have been put on the table. Of course, whether the committee uses these proposals as a menu to craft tax legislation, or takes a completely different approach, remains to be seen.

Potential individual tax changes

- Absent any extension or modification, the "Bush tax cuts" will expire at the end of 2012, with various proposals raising rates only for individuals with income above $200,000 and married couples with income over $250,000 and keeping other income levels at current rates
- Tax income related to "carried interests" at ordinary rates
- Replace current tax rate structure with three new brackets ranging from 8 to 12 percent, 14 to 22 percent, and 23 to 29 percent
- Extend or increase the federal estate tax rate of 35 percent and estate tax exemption of $5 million
- Abolish the alternative minimum tax
- Reduce or eliminate certain tax deductions, including home mortgage interest, charitable contributions, and medical expenses
- Repeal the deductions for state and local taxes and miscellaneous itemized deductions
- Extend or reduce the earned income tax credit and child tax credit
- Modify inflation adjustments on certain provisions within the tax code, including regular income tax brackets, personal exemptions, itemized deduction phase-out, and IRA contribution limits and deductions
- Eliminate preferential tax rates for dividends and capital gains
- Raise the federal gasoline tax by 15 cents per gallon

Potential business tax changes

- Permanently extend the research and experimentation credit
- Eliminate the LIFO inventory method
- Extend the 2011 payroll tax cut
- Abolish the alternative minimum tax
- Reduce the corporate tax rate from 35 percent to somewhere between 23 to 29 percent
- Reduce business incentives such as the Section 199 production activity deduction and LIFO
- Move the corporate tax system from a worldwide system to a territorial system
- Cap the income tax exclusion for employer-provided health insurance
- Eliminate certain oil and gas tax preferences

Sweeping reform may not be practical (or politically achievable) given the committee's abbreviated time frame in which to act; however, we expect to see a first pass at significant changes before the end of 2011.

What does this mean for you? Quite frankly, this creates a great deal of uncertainty regarding the tax law and how to approach year-end, which means you'll need a flexible game plan. Until we know more about the direction the committee will take, our advice is to proceed as if there will be no changes for 2011 or 2012. Keep in mind, the decisions you make now may impact your taxable income in later years. Accordingly, prudent planning requires you monitor developments and incorporate them into your tax and financial planning with the assistance of your Baker Tilly advisor. Once this joint committee makes its recommendations later this year, we will have a better understanding of how the law may affect your financial and tax planning strategies in 2012 and beyond.

For more information or any questions you might have on this topic, we encourage you to contact your Baker Tilly tax advisor or send an e-mail to tax@bakertilly.com.