

Paying the bill for proposed policy initiatives

The choice: Cut spending, raise taxes or both?

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Of President Obama's first term primary objectives, climate change and health care reform top the list, said John P. Gimigliano in an address to the Global Enterprise Institute (see sidebar top right). The third priority is taxes, to which Gimigliano adds a question mark "because it hasn't been decided whether the first two priorities will be paid with spending cuts, taxes or both."

Rather than delving into the intricacies of the health care plan, Gimigliano made an educated assumption about how Congress is likely to fund such a plan. "If they spend \$1 trillion for a health care bill, they have to come up with a trillion dollars of additional revenue somewhere. In the current economic climate they're not going to cut spending; there's no obvious place to cut."

So where will the funding come from?

Look for changes in the tax structure, he said, pointing out that "some in the Administration and in Congress argue that multinationals have not been paying their fair share of taxes."

Although the President wants to cut the business tax burden by almost \$150 billion through measures such as making the research and experimentation tax credit permanent and extending the net operating loss carryback, his plans also include implementing unspecified international enforcement, reform deferral and other tax reform policies which are forecast to raise \$210 billion. And if you're a multinational corporation, your taxes are apt to increase. But nothing is cast in stone. "There's just no way to predict exactly how the administra-

tion is going to respond given all the issues they're confronted with," said Gimigliano. "As President, you make a plan and then you realize the plan is worth very little because you have to react to what has happened that day. But the really good presidents and professional people figure out a way to stick to the larger objectives despite all the day-to-day turbulence they see." As for the Obama administration, "it's still too early to make judgments."

One thing is certain: "Every time Congress makes a policy decision, it creates winners and losers," said Gimigliano. "The challenge is to try to minimize the losers, but sometimes you have to make hard decisions and say Sorry."

For the sake of tax planning, businesses need to understand the impact of proposed legislation and whether they fall into the category of winners or losers.

Perfect storm

The line chart below from the Congressional Budget Office (CBO) illustrates the gap between outlays and revenues thru 2019. The challenge for Congress: How to bring those two lines closer together. The reality: "There is no easy answer," said Gimigliano. The outlook for digging out of the deficit, which is estimated at \$1.84 trillion for FY09 and \$1.26 trillion for FY10, "doesn't look good."

The GDP has been falling at the rate

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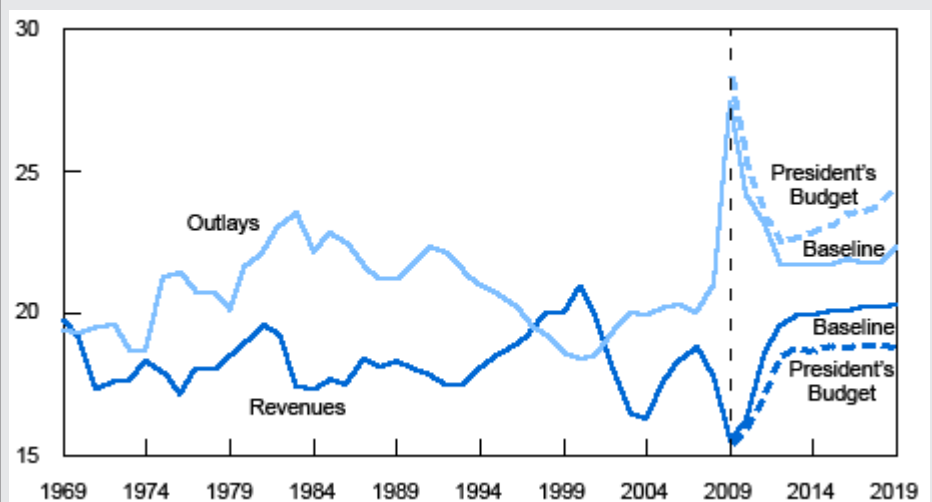
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The GLEI provides a forum for business leaders of mid-market and entrepreneurial firms to access thought-leadership on important issues facing their companies and to discuss emerging trends in international business.

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of 1.5 percent in calendar year 2009 and is forecast to end up in negative territory. According to CBO projections based on assumptions about tax revenues, interest rates and other economic data, the GDP in 2010 is going to grow to 1.4 percent. "A lot of economists think this figure is too rosy," said Gimigliano. And while lawmakers don't agree on the best way forward, "addressing the economic crisis now trumps

Fiscal picture – Outlays and Revenues as a % of GDP



Source: Congressional Budget Office (CBO) March 2009

long-term deficit considerations.”

Outside the halls of Congress, a perfect storm is brewing: “A confluence of tax cuts set to expire Dec. 31, 2010.” Instituted in 2001 and 2003, “these are very expensive tax cuts and include individual income tax rates, child credit, marriage penalty, dividends, capital gains rates and the estate tax,” said Gimigliano.

“The 10-year cost of extending all tax provisions scheduled to expire before 2018: \$3.8 trillion.”

Slated for modification is the individual Alternative Minimum Tax (AMT) which if repealed would cost the government nearly \$800 billion in foregone tax revenue over a 10-year period.

Originally the AMT was designed to ensure that the wealthiest folks did not escape paying some taxes; however, middle- and upper-middle-income taxpayers have been hardest hit. In order to mitigate this unintentional result, Congress in 2008 (as it has done in preceding years) added a “patch” to the \$700 billion financial bailout package. The 2008 AMT patch raises the exemption for married couples filing jointly to \$69,950, for single filers or heads of households to \$46,200 and for married people filing separately to \$34,975.

Without the patch, the exemption would have reverted to pre-2001 rates:

\$45,000 for married couples filing jointly, \$33,750 for single filers.

“The 2009 Obama budget extends the AMT patch, raises the exemption level and prevents a tax increase from being levied on the 33 million taxpayers expected to be on the AMT by 2010,” said Gimigliano.

Included in the Obama budget is “restoration of the personal exemption phase-out (PEP) and Pease, which places limitations on itemized deductions,” said Gimigliano. PEP and Pease raise taxes for some taxpayers with incomes above \$140,000. PEP reduces the value of personal exemptions for wealthier taxpayers. Pease applies to both married and single taxpayers with adjusted gross income of more than \$145,950.

ARRA’s big winner

Energy is the big winner under the Obama administration’s American Recovery and Reinvestment Act (ARRA) of 2009. Said Gimigliano, “Energy – specifically renewables – is poised to cease being an industry segment and to emerge as an economy-wide movement.”

If renewable energy is the winner, who is the loser? Losers are likely to be those entities that relied on existing provisions to limit their tax liability. These include high net-worth individuals, fossil fuel companies and multinational corporations,

Gimigliano said.

To help renewables claim the winner’s blue ribbon, “decision-makers are preparing a three-pronged federal strategy designed to create demand for renewables, make the government the lender of choice and provide deeper subsidies up and down the renewables supply chain,” said Gimigliano, highlighting some of the features in Waxman-Markey, a bill that runs more than 1200 pages.

■ Create demand

Cap and trade. With the goal of combating global warming, “cap and trade legislation, if passed, would incrementally reduce emissions of pollution-causing greenhouse gases to below 2005 levels, starting with 3 percent in 2012 and reaching 83 percent in 2050.” (See sidebar below.)

Cap and trade legislation creates an incentive for polluting facilities to implement the most cost-effective emissions reduction options and puts a price on global warming pollution, thus encouraging investments in new low-carbon technologies and generating subsequent demand as the technologies proliferate in the market.

Gimigliano did not have a crystal ball when he spoke to the GEI on June 17. At the time he felt the prospects for the passage of cap and trade legislation were uncertain.

On June 27, despite strong opposition on both sides of the aisle and from various industry organizations, fossil fuel companies and think tanks, the Waxman-Markey Bill passed the House. The consensus now is that it faces an uphill struggle in the Senate.

■ Lender of choice

Tapping into ARRA loan guarantees and upfront cash grants, investors have a friend in the US Treasury Department. A proposed Clean Energy Deployment Administration would provide low-interest direct government loans to developers as well as guarantees on loans made privately.

■ Deeper subsidies

“The ARRA includes a significant number of energy incentives that may help alleviate current financing issues and encourage continued energy investment, particularly in the renewables sector,” said Gimigliano. These include a three-year extension of the Production Tax Credit (PTC), election of the Investment Tax Credit (ITC), a new Treasury grant program that Gimigliano said represents “real change,” new investment tax credits for advanced energy manufacturers which allocate \$2.3 billion in tax credits while they last, and tax credit bonds for renewables. ♦

Cap and Trade Legislation

Lead bill: Waxman-Markey (HR 2454) in House of Representatives

What is it?

Establishes a market-based program for reducing global warming pollution from electric utilities, oil companies, large industrial sources, and other covered entities that collectively are responsible for 85 percent of US global warming emissions.

- Entities that emit less than 25,000 tons per year of CO2 equivalent are not covered by this program.
- The program reduces the number of available allowances issued each year to ensure that aggregate emissions from the covered entities are reduced by 3 percent below 2005 levels in 2012, 20 percent below 2005 levels in 2020, 42 percent below 2005 levels in 2030, and 83 percent below 2005 levels in 2050.

Offsets

- Allows covered entities to increase their emissions above their allowances if they can obtain “offsetting” reductions at lower cost from other sources.
- The total quantity of offsets allowed in any year cannot exceed 2 billion tons, split evenly between domestic and international offsets.
- Covered entities using offsets must submit five tons of offset credits for every four tons of emissions being offset. *Monitored by the Offsets Integrity Advisory Board.*

Banking and borrowing

Permits unlimited banking of allowances for use during future compliance years. The draft also establishes a rolling two-year compliance period, effectively allowing covered entities to borrow from one year ahead without penalty.

Source: John Gimigliano, KPMG LLP