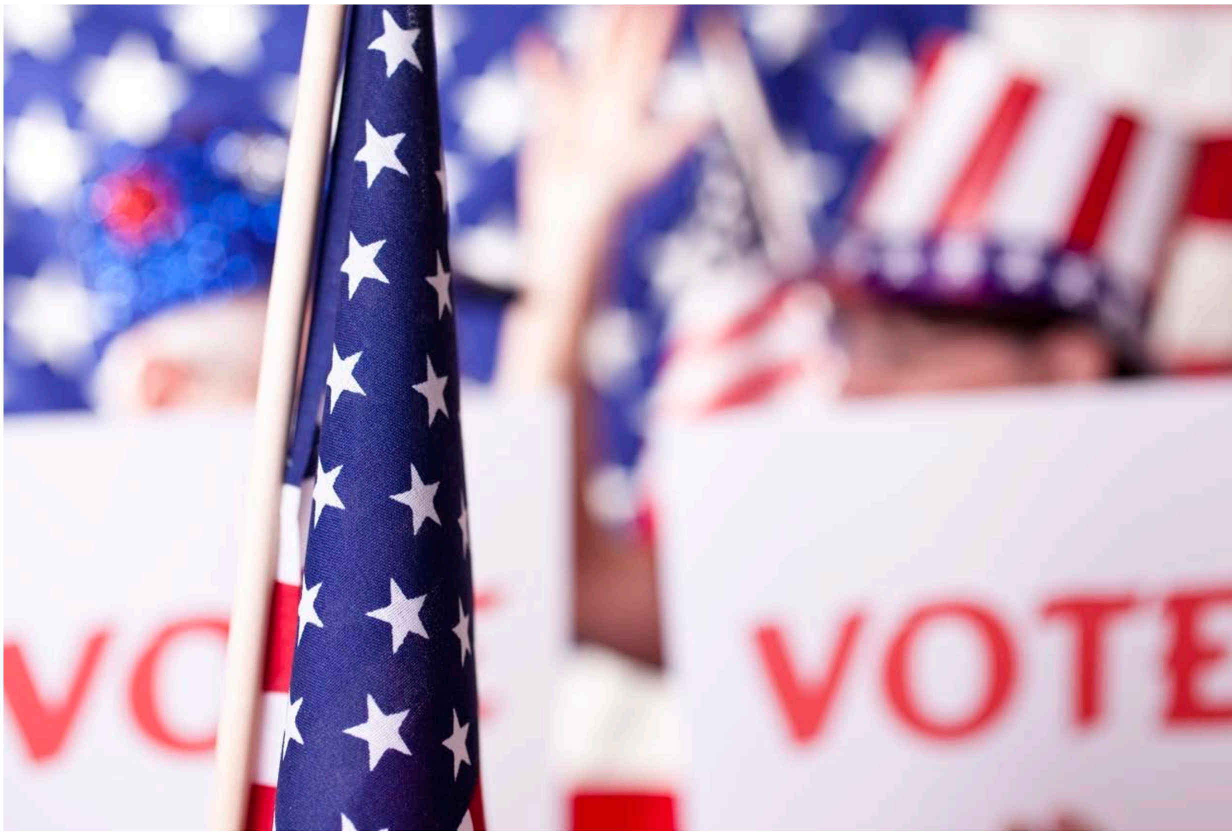

Post-election perspective

Results leave tax policy outlook uncertain in the short term

November 5, 2014

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The shape of the next Congress

The November 4 midterm elections have resulted in a shake-up on Capitol Hill that will put Republicans in charge of the legislative agenda — including tax policy — in the House and the Senate when the 114th Congress convenes in January.

Overview

According to the latest returns available as this publication went to press, Republicans will expand their majority in the House next year by at least 14 seats for a total of 243, compared to 178 for the Democrats (and 14 still too close to call). But the GOP has also won control of the Senate with a net gain of at least 7 seats for a majority of 52, compared to 43 for the Democrats and 2 for Independents. The two Independents — Sen. Bernie Sanders of Vermont and Sen. Angus King of Maine — caucused with the Democrats in the 113th Congress and will continue to do so once the new Congress is sworn in. King had hinted earlier this year that he might align with the GOP in 2015 in the event of a Republican takeover, but confirmed on November 5 that he would remain on the Democratic side of the aisle.

At press time, three Senate races remain undecided, including Alaska (where votes are still being counted), Virginia (where the margin separating the Democratic incumbent and the Republican challenger is razor thin), and Louisiana (which will be decided a in run-off to be held on December 6).

While the election results place control of both chambers of Congress under one party, it is less clear whether they remove enough of the impediments that can block the passage of major legislation such as tax reform. Pending leadership changes on the congressional taxwriting committees, the complexities of the Senate's procedural rules, and the fact that Democrats still control the White House for the next two years are all factors that make it difficult to determine whether the GOP can move significant tax bills through the legislative process and get them to the president's desk in the near term.

Leadership in the House and Senate

The fact that the GOP remains in control of the House presumably clears the way for Rep. John Boehner, R-Ohio, to remain as speaker in the 114th Congress, although he could face a challenge for the top spot from the more conservative wing of the GOP conference.

Speaker Boehner is widely believed to enjoy the continued support of a majority of his House GOP colleagues. But even though that level of support is sufficient for someone who is running for a party leadership post such as majority leader or whip (where a candidate wins with a simple majority of votes cast in the House Republican Conference), it is not necessarily enough for someone running for speaker. That position is chosen by the entire House — Republicans and Democrats alike — and a candidate must secure an absolute majority of the House's 435 members — i.e., 218 votes — to be elected to the post.

Boehner has faced such an intra-party challenge for the speaker's gavel in the past. At the start of the 113th Congress in 2013, a small group of GOP members who were concerned with his leadership mounted an attempt on the House floor to deny him the 218 votes he needed to be re-elected speaker. Several voted against him, but not enough to derail his bid for the speakership. Although none of his House Republican colleagues have as yet publicly declared that they intend to challenge Boehner, this is an issue that bears watching. Even if no other House Republican[1] runs against him when the party chooses its nominee for speaker later this month, a small contingent could try once again to deny him a majority when the entire House chooses the speaker in January. Given the GOP successes at the ballot box, which substantially increased the size of the Republicans' majority in the House, it appears unlikely that such a challenge would impact the organization of the chamber, however.

[1] As the Constitution does not require that the speaker be a House member, the House could elect anyone to that position. While that theoretical possibility exists — in fact, during the failed effort in 2013 to deny Boehner a second term as speaker, votes were cast for a former congressman, a former cabinet secretary, and a former head of the Government Accountability Office — it is viewed as all but certain that the House will continue to fill that important role with a duly elected member of Congress.

In the Senate, the GOP's takeover means that current Minority Leader Mitch McConnell of Kentucky, who won another term after defeating Democratic challenger Allison Lundergan Grimes, is likely to become the new majority leader in the 114th Congress. Nevada Democratic Sen. Harry Reid, the current majority leader in the Senate, will step down from that post in January and presumably will become the new minority leader.

Leadership changes on the taxwriting committees

The 114th Congress will see new leaders on both the House Ways and Means Committee and the Senate Finance Committee — the two congressional panels that are responsible for writing tax law and generally regarded as the front lines for efforts to reform the tax code.

Ways and Means — House Ways and Means Committee Chairman Dave Camp, R-Mich., did not seek re-election in 2014 and will leave Capitol Hill when his current term in office expires at the end of this Congress. Since the GOP has retained control of the House, Camp will be replaced as Ways and Means chairman by another Republican. Two current taxwriters have already thrown their hats in the ring for the position:

- The first, Texas Republican Rep. Kevin Brady, who currently chairs the Ways and Means Health Subcommittee, is the most senior member of the panel expected to seek the chairmanship. (Fellow Texan Sam Johnson has more seniority on the committee than Brady, but Johnson is unlikely to seek the gavel for himself.)
- The second, Wisconsin Rep. Paul Ryan, is the current chairman of the House Budget Committee and was Mitt Romney's running mate in 2012.

The House Republican Conference is expected to select the next chairman later this month. Although Ryan has slightly less seniority than Brady, most observers believe that Ryan is likely to get the nod to head the taxwriting panel.

Exactly how the tax reform debate would proceed under new leadership is unclear. If Ryan is selected to chair the panel, some clues to his priorities can be found in the fiscal year 2015 budget blueprint that he moved through the House earlier this year. That budget blueprint calls in general terms for revenue-neutral tax reform that would cut the top corporate and individual tax rates (with a goal of 25 percent on the individual side), reduce the number of individual income tax brackets to two, eliminate the alternative minimum tax, and move toward a more competitive system for taxing the income of U.S. multinationals. Significantly, however, it stops short of explicitly calling for enactment of the tax reform discussion draft that current Ways and Means Chairman Camp released in February of this year. Instead, Ryan's budget blueprint urges Congress to consider "the full myriad of pro-growth plans" as it contemplates tax reform. While this is by no means a repudiation of Camp's discussion draft, it does suggest that Ryan was providing some cover for fellow Republicans who were nervous about certain aspects of Camp's proposal. It also opens the door for Ryan to put his own stamp on tax reform in the future. Ryan has recently staked out some specific policy positions, expressing support for limiting the mortgage interest deduction and expanding the child tax credit but rejecting a cap on the deduction for charitable giving.

If Brady is selected as chairman, he, too, is seen as a strong proponent of base-broadening and rate-reducing tax reform which moves the U.S. toward a territorial tax system. Brady, who in addition to serving on Ways and Means is also chairman of the congressional Joint Economic Committee, has called for implementing "pro-growth tax reform that creates more taxpayers and makes it easier to file and pay taxes in America." In remarks at a recent conference of tax professionals, Brady floated the idea of reducing the corporate income tax rate to 20 percent, emphasized the importance of cost recovery, and referred to so-called dynamic scoring of tax legislation as "critical for tax reform." He has also advocated, among other things, repealing the estate and gift tax, retaining the deduction for state and local sales taxes, making the research credit permanent, retaining current-law tax expenditures for oil and gas companies, and ending tax subsidies for alternative and renewable energy.

Finance Committee — With control of the Senate shifting to the GOP in 2015, Finance Committee Chairman Ron Wyden, D-Ore., will relinquish his gavel and current Finance Committee ranking Republican Orrin Hatch of Utah will most likely become the taxwriting panel's new leader.

Hatch is a proponent of tax reform and worked with then-Finance Committee Chairman Max Baucus, D-Mont., in 2013 to lead the committee members through an examination of a number of discrete policy issues in tax reform that culminated in the release of a series of "options papers" outlining possible approaches to revamping specific areas of the tax code. Hatch also collaborated with Baucus on a project to encourage members of the Senate to submit detailed policy arguments explaining which current-law tax expenditures should be eliminated and which should be retained in a future tax reform effort.

In the 114th Congress, Hatch would be expected to work with a Republican-controlled House in moving reform legislation, but he has not yet released a tax reform plan of his own. In an October 8 speech outlining his vision of a GOP policy agenda, Hatch argued in broad terms that tax reform should "encourage job creation and economic growth by making the tax code more internationally competitive, reducing distortions, eliminating overt obstacles to growth, and lowering both individual and corporate rates." A reformed tax code also should "promote simplicity and fairness," "provide permanence and certainty," and "boost saving and investment," he said.

Other taxwriting committee changes — Changes are also pending to the roster of rank-and-file taxwriting committee members in both chambers.

In addition to Ways and Means Chairman Camp, House taxwriters not returning for the 114th Congress include Reps. Jim Gerlach, R-Pa., Tim Griffin, R-Ark., and Allyson Schwartz, D-Pa. The number of seats each party controls on the committee varies each year, depending on each party's share of overall House seats. With the GOP adding to its majority by at least 14 seats this year, the party ratio on Ways and Means may change.

In the Senate, senior Democratic Finance Committee member Jay Rockefeller of West Virginia did not seek re-election. Because the GOP won control of the Senate, however, party ratios on the Finance Committee will change from their current levels of 13 Democrats and 11 Republicans. As a result, the GOP can be expected to add new members to the panel next year; Democrats, meanwhile, may have to let the vacant seat created by Rockefeller's retirement go unfilled and possibly may lose a seat currently held by a junior member of the committee.

Serving on the Ways and Means or Senate Finance Committees is considered an attractive assignment, and many members have already expressed interest, either privately or publicly, in winning a spot on one of these two panels.

In the House, Republicans Kristi Noem of South Dakota and Pat Meehan of Pennsylvania are among those expected to seek a seat on Ways and Means. On the Democratic side of the aisle, Rep. Chris Van Hollen, who is currently ranking member of the Budget Committee, could seek to reclaim a seat on the taxwriting panel if there is an opening. (Van Hollen took a leave of absence from Ways and Means to ensure that Rep. Schwartz was able to keep her seat on the panel when Republicans claimed the House majority after the 2010 elections.) Other former Ways and Means Democrats who lost their seats on the committee after the 2010 election and may wish to rejoin the panel include Reps. John Yarmuth of Kentucky and Brian Higgins of New York. House Democratic Reps. Gwen Moore of Wisconsin and Karen Bass of California are also thought to be interested in being appointed to the panel.

Names mentioned as possible new GOP appointees to the Senate Finance Committee include Dean Heller of Nevada and Dan Coats of Indiana. However, because Senate Republican rules give the Republican leader substantial responsibility for filling these committee seats, questions about the taxwriting roster are particularly difficult to discuss from the outside with a high level of certainty.

Assignments to both panels are likely to be made before the end of the year.

Looking ahead to 2015: Can tax reform move forward?

Republicans have long called for an overhaul of the federal tax code and their victories in the midterm elections arguably give them a stronger hand in shaping tax reform proposals in the new Congress. Moreover, tax reform is one issue that — in general terms, at least — enjoys support in both parties and at both ends of Pennsylvania Avenue. If each party wants to use 2015 as an opportunity to show the country that Washington is capable of governing, the stated interest in tax reform by Democrats and Republicans and the spadework that has been done to this point — for example, Ways and Means Chairman Camp's discussion draft, his bipartisan efforts with former Senate Finance Committee Chairman Baucus last year to educate lawmakers and the public on issues in tax reform, and current Finance Chairman Wyden's comprehensive tax reform proposals from 2010 and 2011 — could help propel the issue forward.

Nonetheless, there are several factors that could provide ample opportunities for continued gridlock.

- First, the GOP has yet to coalesce around any of the reform proposals that various lawmakers — including the outgoing Republican chairman of the House Ways and Means Committee — have advanced over the past year. Moreover, as already noted, leadership changes are pending on both the Ways and Means Committee and the Senate Finance Committee, and those new leaders likely will want time to put their own stamp on tax reform.

- Second, even if GOP lawmakers reach consensus on a specific reform proposal, the Republicans' margin of victory in the Senate does not leave them with a large enough majority to avert the threat of a Democratic filibuster that can keep legislation locked in procedural limbo.

- Third, even though Republicans have consolidated power in Congress, they still must deal with a Democratic president who has his own priorities when it comes to tax reform and could exercise his veto authority if presented with legislation he finds unacceptable. And while President Obama has expressed his general support for tax reform, he has not offered a detailed proposal of his own, nor has he actively sought to negotiate a plan with congressional Republicans or made a sustained effort to engage the public on — and build a base of support for — his vision of a reformed tax code. In the wake of the elections, it is unclear whether he will be more or less likely to engage in an effort to find common ground on tax reform than he has been in the past.

- Fourth, on a related note, while policymakers generally agree on the need for tax reform, the two parties have not yet resolved fundamental differences over what tax reform should accomplish. For example, one key issue that will need to be addressed is whether reform should produce more overall revenue for deficit reduction (as Democrats generally want) or whether it should be revenue neutral (as Republicans generally prefer). Another long-standing area of disagreement is whether tax reform should be used to address income inequality (as Democrats generally want) or whether the tax code is already sufficiently progressive and doesn't need to be made more so (as Republicans generally agree).

- Finally, there are other key legislative issues that Congress and the White House will have to address early in 2015 including the debt ceiling, a continuation of current payment levels to physicians serving Medicare patients (the so-called Medicare Doc Fix) and reauthorization of the highway trust fund. All of these issues fall under the jurisdiction of the taxwriting committees and thus may consume time that taxwriters otherwise might devote to tax reform.

Whether tax reform can advance in 2015 or will remain mired in partisan and procedural disputes will become clearer as the new congressional session unfolds next year. In the coming weeks, Deloitte Tax will publish a broader examination of how the tax reform debate developed in the last two years and examine in greater detail how the debate may play out over the next two years.

Unfinished business for the current Congress: Lame Duck preview

It is not immediately clear what impact — if any — the election results will have on the congressional lame duck session, which begins on November 12. Those details are likely to fall into place in the coming days as contested races are finalized and the current House and Senate leadership — who still control the legislative process — assess what they can and cannot accomplish.

Nontax issues take center stage

Nontax issues that could consume floor time during what is expected to be a relatively compressed post-election legislative session include passage of a continuing resolution to fund government operations and action on executive branch and judicial nominations. (With the Senate coming under Republican control next year, Democrats in that chamber may devote substantial time and energy to the confirmation process while President Obama's nominees can be cleared with just 51 Democratic votes). Responses to threats posed by ISIS and the Ebola epidemic also could claim time on the agenda. Moreover, President Obama may issue some executive orders on deportation of undocumented individuals, and that would be expected to spur legislative activity — but probably not lawmaking — on Capitol Hill.

Extenders

The most pressing tax issue facing lawmakers when they return for the lame duck session is legislation addressing the future of the research credit, bonus depreciation, and dozens of other temporary tax deductions, credits, and incentives that expired at the end of 2013.

The Senate Finance Committee in April approved a two-year extension (through 2015, retroactive to the end of 2013) of most — but not all — of the expired tax provisions, with an eye toward giving Congress more time to evaluate each provision and determine whether it should be extended permanently or stricken from the tax code as part of a future tax reform effort. Although the legislation was approved in the Finance Committee with bipartisan support, it has not received a vote on the Senate floor due to a dispute between Majority Leader Harry Reid and Senate Republicans over a process for offering amendments.

Across the Capitol, House Republican leaders opted to move permanent extensions of discrete extenders provisions rather than another broad temporary package as Congress has done in the past. Since May, the chamber has approved separate bills that would permanently extend the research credit, bonus depreciation and the election to accelerate AMT credits in lieu of first-year bonus depreciation, increased section 179 expensing limits, the reduced recognition period for S corporation built-in gains tax, the above-the-line deduction for qualified tuition and related expenses, tax-free distributions from individual retirement plans by individuals age 70-1/2 and older for charitable purposes, special rules for contributions of capital gain real property made for conservation purposes, the enhanced deduction for charitable contributions of food inventory, and the basis adjustment to stock of S corporations making charitable contributions of property. (All these provisions would take effect retroactively to December 31, 2013.)

The House's "permanent extenders" strategy was advanced by Ways and Means Chairman Camp as a way of building the budget baseline to make tax reform a less expensive proposition for a future Congress. (The idea is that building extenders into the budget baseline would make reform much easier because it would lower revenue targets and, in turn, give taxwriters more flexibility as they make decisions about what base broadeners would be necessary to achieve the desired level of rate reduction.)

Exactly how the two chambers will reconcile their competing approaches to extenders is currently unclear. Nevertheless, given the bipartisan support for addressing these provisions, we anticipate that most will be extended for the two year period 2014 and 2015. A few might be made permanent (such as the research credit), and it is possible that a very select few are not extended at all, making this something that bears close watching in the coming weeks.

For additional discussion on congressional extenders proposals, see *Policy, politics, and the prospects for tax extenders*, a new report from Deloitte Tax LLP (available at http://www.deloitte.com/view/en_US/us/Services/tax/1a5092a2c7259410VgnVCM2000003356f70aRCRD.htm).

Potential filing season impact — IRS Commissioner John Koskinen recently warned that congressional inaction on extenders could have a detrimental impact on the upcoming income tax filing season.

"If this uncertainty persists into December, we could be forced to postpone the 2015 filing season," Koskinen said. "This would delay the start of processing of tax refunds for millions of taxpayers."

A delay in the start of the filing season could have an impact on issues related to a further extension of the debt ceiling. The current debt limit suspension expires on March 15 of next year, although Treasury is expected to be able to use what it has called "extraordinary measures" to extend that deadline by several weeks or even months. But that timing could shift in not necessarily predictable ways if the filing season is delayed so that the flow of tax payments and tax refunds is altered.

Internet tax moratorium

Shortly before adjourning for their final round of pre-election campaigning, both chambers voted to extend the Internet Tax Freedom Act (ITFA) through December 11. The ITFA, which had been scheduled to expire November 1, imposes a moratorium on state and local Internet access taxes and provides grandfathering protections for Internet access taxes that were levied in certain states before 1998.

The House has passed legislation that would permanently extend the moratorium on taxes on Internet access but allow the grandfathering protections for certain pre-1998 taxes to expire.

In the Senate, Finance Committee Chairman Wyden has introduced his own proposal to make the moratorium permanent and allow the grandfathering protections to sunset, but he has not yet held a committee mark-up. Wyden's efforts to move his bill have been complicated by the introduction of competing legislation that would couple a 10-year extension (through November 1, 2024) of the Internet access tax moratorium and the grandfather rules with provisions from the Marketplace Fairness Act that would make it easier for a state to capture sales and use tax revenue from transactions involving online and other "remote" vendors that do not have an in-state physical presence. That legislation is sponsored by Finance Committee member Mike Enzi, R-Wyo., and Senate Majority Whip Richard Durbin, D-Ill., among others.

Wyden opposes the Marketplace Fairness Act, and his challenge during the lame duck session will be to keep the Senate debate over the Internet access tax moratorium separate from discussions about collecting state and local sales tax on remote transactions.

Timeline

The first chunk of the lame duck session is expected to be dominated by "housekeeping" issues in both chambers, though we will all be watching intently for early signals as to how extenders and other lingering issues may be resolved.

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