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Tax Policy Update: The Emerging Fall Fiscal Cliff

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A. September 30: Government Funding Resolution

1. Expiration of Governmental Funding

The current funding of the federal government will expire on September 30, 2015, with the end of the current fiscal year. Prior to the August recess, the appropriations process for FY 2016 came to a halt in both the House and Senate. In light of the compressed time available for legislation in September (due to the Iran legislation, the Pope's visit and religious holidays), a continuing resolution (CR) is expected to be passed, keeping the government open for some brief period of time to allow for negotiations on a funding resolution for the balance of FY 2016. It should be noted, however, that passage of a temporary CR may be complicated by an ongoing policy dispute regarding federal funding for Planned Parenthood.

With respect to funding the federal government for the balance of the new fiscal year, congressional Democrats are seeking negotiations on appropriations for FY 2016 in order to provide relief from the statutory sequesters enacted in 2011 as part of the Budget Control Act of 2011. Under that act, discretionary federal spending is statutorily capped, with the limits on both defense and nondefense spending enforced by separate sequesters (across-the-board spending cuts) for each year from 2013-2021. Under the sequestration caps currently in effect, nominal discretionary appropriations would rise only by $3 billion (0.3 percent) in FY 2016. (Note: The statutory spending caps and sequesters apply to only appropriated spending and not to mandatory or entitlement spending, such as Social Security, Medicare or Medicaid.)

The budget resolution for FY 2016 passed earlier this year by congressional Republicans would provide sequester relief for defense spending while maintaining the sequester cap on nondefense spending. President Obama has proposed increasing overall discretionary spending by $74 billion in FY 2016 above the sequester caps for both defense and nondefense spending. In a report issued on August 11, 2015, the Congressional Budget Office (CBO) indicated that eliminating the sequester caps for both defense and nondefense spending for FY 2016 would allow overall federal spending to increase by $90 billion.

In 2013, a compromise (the Bipartisan Budget Act of 2013) struck by Rep. Paul Ryan (R-WI) and Sen. Patty Murray (D-WA)—at the time, both chairmen of their respective House and Senate Budget Committees—provided sequester relief for FY 2014 and FY 2015. Some members of Congress are hopeful that a similar "sequester relief" compromise can be negotiated for FY 2016. It is important to note that the 2014 Ryan-Murray compromise provided sequester relief for both defense and nondefense spending, and it included compensating spending reductions and revenue enhancements (although not "tax increases") to preserve the overall level of deficit reduction enacted in the 2011 Budget Control Act. Some version of the 2014 Ryan-Murray compromise could become a template for a similar sequester relief package this fall.

2. Funding for the Federal Aviation Administration

Funding for the Federal Aviation Administration (FAA), including the air traffic control system, is scheduled to expire on September 30, 2015. Complicating the funding issue debate is the interest of some members of Congress to privatize various air traffic control functions. In light of the crowded legislative agenda this fall, Congress may pursue a temporary extension of funding for the FAA to avoid furloughs of air traffic controllers and to provide additional time for resolving both the funding and privatization issues.

B. October 29: Expiration of the Federal Highway Program

Prior to the August recess, Congress passed another short-term extension of the highway trust fund, extending the program through October 29, 2015, with general revenue financing provided by a variety of revenue enhancements. The Department of Transportation estimates that these enhancements will help maintain trust fund solvency through the third quarter of FY 2016. However, program authorizations will continue to expire on October 29, 2015, without further legislative action. Senate Republican leaders have proposed a multiyear extension of the highway program beyond the 2016 national elections. To this end, the Senate has passed a six-year reauthorization of the highway program, with revenues sufficient to fund the program for approximately three years with an infusion of additional general revenues, but with no increase in the federal gas tax. The Senate-passed bill also includes an extension of the Export-Import Bank (Ex-Im), which is controversial with some members of Congress.

In the House, Ways and Means Committee Chairman Ryan has expressed support for advancing an international tax reform package to help pay for a long-term extension of the federal highway program. It appears that Chairman Ryan has been joined in this effort by the administration and some committee members—from both sides of the aisle. The administration has expressed particular interest in increasing infrastructure spending by $150 billion over the next six years. In addition, Sens. Rob Portman (R-OH) and Chuck Schumer (D-NY), co-chairs of the Senate Finance Committee working group on international tax reform, have encouraged this developing effort.

The tax policy issues that appear to be under consideration in the context of the international tax reform debate include (1) a change from the current U.S. worldwide taxation system to a form of territorial or dividend exemption system; (2) a mandatory or "deemed" repatriation of offshore earnings currently "trapped" abroad—with possibly different tax rates for liquid and reinvested earnings (revenues raised by this policy change have been proposed to be used in this context to fund infrastructure spending); (3) a "patent" or "innovation" box with favorable tax rates for income derived from intellectual property (Note: Prior to the August recess, Reps. Charles Boustany (R-LA) and Richard Neal (D-MA) advanced an innovation box discussion draft—the Innovation Promotion Act—a draft similar to the innovation box concept in the working group report authored by Sens. Portman and Schumer); and (4) unspecified revenue offsets, including possible changes to the deductibility of interest and research and experimental expenses, as well as policy proposals made by the OECD Base Erosion and Profit Shifting (BEPS) project.

It is important to note that Senate Majority Leader Mitch McConnell (R-KY), and Senate Finance Committee Chairman Orrin Hatch (R-UT) have expressed a preference for keeping international tax reform and long-term funding for the federal highway program on two separate legislative tracks. Therefore, the prospects and prioritization of these two important tax policy issues will have to be resolved this fall by and among congressional leaders and the administration.

C. Late Fall: The Debt Ceiling

The current statutory debt ceiling is $18.1 trillion. The statutory suspension of the ceiling expired on March 16, 2015. Since that time, the Treasury Department has been utilizing "extraordinary debt management measures" to avoid default. However, on July 29, 2015, Treasury Secretary Jack Lew officially notified Congress that the debt ceiling will have to be increased (or suspended again) by the end of October 2015, or soon thereafter (depending on the level of federal receipts). Secretary Lew is expected to provide Congress with another debt ceiling update soon after it returns to session in September. In addition, on August 25, 2015, the CBO issued a report indicating that debt ceiling legislation will be needed by mid-November to early-December 2015 to avoid default.

It should be noted that, when the debt ceiling was last considered by Congress in February 2014, Congress chose to suspend the limit for 13 months to put the debt ceiling issue and any prospect of default beyond the 2014 mid-term elections.

It should also be noted that the informal "Boehner Rule" (requiring federal spending to be reduced, dollar-for-dollar, for any increase in the debt ceiling) was instituted in the Budget Control Act of 2011 when the debt ceiling was increased. In addition, the Budget Control Act gave rise to the "McConnell mechanism" for increasing the debt ceiling by which the President could request an increase in the debt ceiling that would take effect unless a disapproval resolution is passed by Congress (including an override of the anticipated presidential veto). It will be interesting to see whether the Boehner Rule or McConnell mechanism resurfaces in the context of the debt ceiling debate this fall.

D. December 31: Extension of the "Tax Extenders"

Approximately 55 temporary tax provisions (the "tax extenders") expired at the end of 2014. The House has passed several extenders on a permanent basis in separate legislation, including the research and development tax credit, the state sales tax deduction, the small business expensing and a variety of charitable tax incentives. Chairman Ryan has indicated that he intends for the House Ways and Means Committe to consider the balance of the tax extenders at some point this fall. It should be noted that a permanent extension of all the tax extenders (including bonus depreciation and various tax credits) is estimated to cost approximately $940 billion.

In the Senate, the Finance Committee has approved a two-year extension of all the tax extenders through 2016. The Finance Committee-approved extender package has not yet been scheduled for consideration by the full Senate.

Neither tax committee is expected to "pay for" or offset the budgetary cost of the tax extenders. At the time of markup, the Senate Finance Committee extender package was estimated by the Joint Committee on Taxation staff to cost approximately $96 billion over a 10-year period, using traditional scoring conventions. However, post-markup, the Joint Committee on Taxation staff estimated that the Senate Finance Committee extender bill would cost approximately $86 billion using the dynamic scoring conventions instituted in the 114th Congress.

E. Other Possible Tax or Budget Legislation this Fall

1. Funding for the Social Security Disability Insurance Program

On July 22, 2015, the Social Security and Medicare trustees released their annual report on the financial condition of the Social Security and Medicare programs. The trustees' report served notice to the public and Congress that the Social Security Disability Insurance (SSDI) program is expected to be insolvent by late 2016. In the absence of legislation, the trustees project that disability benefits to approximately nine million beneficiaries will be reduced by 19 percent next year.

In light of this insolvency risk, both tax committees have begun the process of considering possible legislative responses, including (1) the possibility of reallocating social security payroll taxes that support the SSDI program and the old-age retirement and survivors' program, (2) interfund borrowing between the retirement program and the disability program, and (3) programmatic changes to the SSDI program itself. It should be noted that a change to the House Rules, adopted at the beginning of the current Congress, requires any reallocation of payroll taxes to be accompanied by provisions that would improve the overall financial health of the combined Social Security program. It is also anticipated that any legislation advanced to address the SSDI issue will not involve any new taxes on employers or employees.

2. Reconciliation

The FY 2016 budget passed by Congress earlier this year establishes a "reconciliation" process, which allows a budget reconciliation bill to be considered and passed in both the House and Senate by majority vote only. As of this writing, a reconciliation bill has not been advanced in either the House or Senate (and may yet be postponed until 2016). However, congressional Republicans have expressed an intention to use the reconciliation process to repeal as much of the Affordable Care Act of 2010 as possible. Under the rules and procedures of reconciliation, the underlying provisions of a reconciliation bill must have a "budget effect," and, thus, not all provisions of the Affordable Care Act could be included in a reconciliation bill. In addition, any reconciliation bill proposing a repeal of all or some parts of the Affordable Care Act is likely to be vetoed by President Obama, requiring a two-thirds vote in both houses of Congress to override the President's anticipated veto—a legislative hurdle that would be difficult, if not impossible, to achieve.

3. Possible Need for Additional Budgetary Offsets

In addition to the issues discussed above, one or both houses of Congress may consider initiatives this fall that require budgetary offsets—either spending cuts or revenue increases—to comply with budget enforcement rules or to avoid budgetary points of order.

Such initiatives could include:

- a successful conclusion and submission to Congress of the Trans-Pacific Partnership trade agreement
- consideration by the full Senate of the multiple miscellaneous tax bills approved earlier this year by the Senate Finance Committee
- repeal or modification of various health-related taxes, such as the medical device tax or the excise tax on so-called "Cadillac" tax plans.

Any of these initiatives, as well as others, could have budget effects requiring consideration of budgetary offsets.

Conclusion

Many major tax and budget issues will be actively in play this fall—with calendar deadlines driving much of the timing and decision making by Congress. Critically important issues will dominate, including avoiding a government shutdown by funding the federal government for the upcoming fiscal year and avoiding an unprecedented and catastrophic default on the national debt. In addition, significant tax issues will also be actively debated, including long-term reauthorization and financing of the nation's highway program and the possibility of international tax reform.

Looming over all these issues is the revenue question and whether offsets will be needed for a variety of policy initiatives or legislative compromises. In this complicated and uncertain legislative environment—a policy environment with great potential and great vulnerability—

parties must be well represented by sophisticated and experienced counsel to secure favorable policy outcomes.

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