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**The Tax-Conscious Adviser**

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# Cap deductions to balance the budget

Both presidential candidates want to limit their value but would go about it differently

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President Barack Obama and former Massachusetts Gov. Mitt Romney disagree on a lot of things, but one thing they agree on is limiting federal income tax deductions to help balance the budget.

Every White House budget proposal over the past four years has contained a provision to limit the value of tax deductions. The idea was to cap deductions for those in the highest tax brackets while keeping the tax bills of the middle class from increasing.

Mr. Obama makes the case that a $1 deduction shouldn't be worth more to a high-income taxpayer than to the “average” taxpayer. For someone in the top tax bracket of 35%, a $1 deduction saves 35 cents in taxes. Mr. Obama figures that the average taxpayer is in a 28% bracket and thus saves only 28 cents in taxes for every dollar deducted. Therefore, his budget proposals have included the concept that deductions would be worth only 28 cents on the dollar, no matter what bracket the taxpayer is in.

Congress has not picked up on the concept as of yet, though the Congressional Budget Office calculated the revenue raised if the value of a deduction were limited to 28 cents on the dollar. It also calculated the revenue if deductions were capped at 15 cents on the dollar.

Mr. Romney also sees limiting deductions as the path to budget soundness. The Republican recently floated the idea of allowing a maximum amount of deductions per taxpayer of $17,000.

A more specific proposal has been suggested by Harvard University economist Martin Feldstein; he proposes to cap deductions at a maximum of 5% of one's adjusted gross income. Mr. Feldstein's idea could have a much more dramatic effect on the wealthy than the president's. Under the Romney/Feldstein approach, it would be possible to get no value whatsoever from your deductions once they exceed the cap.

The cap should not be confused with the Pease limitations on miscellaneous itemized deductions, which allow deductions only after they exceed 3% of adjusted gross income. These limits deny only the first deductions, allowing the rest. The Romney/Feldstein proposals deny an unlimited amount of deductions once they exceed the cap. Mr. Obama's idea gives a reduced value to all deductions.

## DENYING ALL DEDUCTIONS

If you think denying deductions is so unfair that it could never be passed, just look at the handful of gross-income-taxing states — such as New Jersey and Massachusetts — that deny all deductions. It may seem unfair to deny deductions for the costs that were incurred to produce that income, but that is exactly what these states do. Leveraged investments likely would be the most negatively affected.

Washington is looking for the grand compromise that would let both sides declare victory in the budget battle, and I believe limiting deductions would do just that.

The Republicans have sworn not to raise tax rates. Though it wouldn't raise rates, the Romney/Feldstein approach would increase taxes.

When Rhode Island recently became a gross-income-taxing state, it made headlines by declaring that it was lowering tax rates and was no longer a high-tax state. This was to be accomplished without decreasing the revenue the state would receive, because the lower tax rate would be applied to a bigger base. The headlines declared lower tax rates, and no one noticed that taxes were actually going higher: The richest 18% of Rhode Islanders saw an increase.

## TAX THE RICH

Mr. Obama has maintained that the middle class is under enough pressure and that the bill to fix the budget should be paid by those earning more than $200,000 and couples earning more than $250,000. By lowering the value of deductions to those in the highest brackets, the president can accomplish his stated goal, as well.

There are lots of articles suggesting that people should look at accelerating income into 2012 to take advantage of the lower tax bracket still in force this year. I propose that there be more discussion about such a tactic. Deductions could be worth more next year if tax rates rise and no limit on deductions is passed, so care should be taken before accelerating anything. Taxpayers should analyze scenarios and plan now for any actions to be taken post-election.

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