Let The Games Begin: Trump's Proposal For Tax Reform

Client Advisories

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I have been a tax lawyer long enough to see a number of major tax overhaul plans come to Congress. This one feels a lot like the original Ronald Reagan plan. President Reagan proposed reducing the number of income tax brackets to three and lowering rates of taxation. He also planned to pay for the tax reductions by eliminating a number of popular deductions. But even Ronald Reagan, who was very popular and a successful communicator, was unable to get all that he wanted. President Trump would be lucky to get half of what he has proposed, but he probably already knows that. Here is a rough outline of the major provisions of Trump's proposal along with observations on each.

INDIVIDUAL TAX PROVISIONS

1. **Increase Standard Deduction**. The standard deduction will be roughly doubled to $24,000 for married taxpayers filing jointly and to $12,000 for single filers. The head of household and married filing separate categories will be eliminated. The personal exemption, which in 2017 reduces taxable income by $4,050 for each dependent, will be eliminated.

Observation. While this simplifies the tax structure, it will adversely affect those claiming multiple exemptions, such as persons with numerous dependents. It will generally reduce tax for those who do not itemize their deductions.

1. **Individual Rate Structure and Child Tax Credit**. The proposal calls for reducing the number of tax brackets from seven (10%, 15%, 25%, 28%, 33%, 35% and 39.6%) to three (12%, 15% and 35%). The Administration's proposal makes no mention of changing the current taxation rate for long-term capital gains. The tax proposal also states that the child tax credit will be significantly increased. It is currently at $1,000 and phases out as one's income level rises.

Observation. While the Administration's proposal shrinks the number of brackets and lowers the highest tax rate, it does not say what the dollar figure will be for each bracket. It also does not say how much the child tax credit will be.

1. **Itemized Deductions**. The Administration's proposal eliminates most deductions but states that tax incentives for home mortgage interest and charitable contributions will be retained.

Observation. This suggests that three significant deductions--the medical expenses deduction, the state and local tax deduction, and miscellaneous deductions--may be eliminated. It is also possible that investment interest deductions will be eliminated or scaled back. The biggest deduction of these is for state and local taxes. Defenders are already lining up to protect that deduction. I would also suggest that after three major hurricanes, it might not sit very well for congressional representatives to deny the casualty loss deduction, which is now classified as a miscellaneous deduction. Finally, the medical deduction, used by the most vulnerable people with large medical expenses, might be very difficult to eliminate.

1. **Alternative Minimum Tax (AMT)**. The Administration proposes that the AMT be repealed. The AMT is designed to limit deductions so that a person cannot use itemized deductions to reduce their tax to too low a figure.

Observation. The Administration's theory is that if most deductions are eliminated, there will be no need for the AMT. This, of course, presumes that most deductions are eliminated, which is extremely unlikely.

1. **Estate and Generation Transfer Tax (GST)**. These taxes are eliminated under the Trump plan.

Observation. Under current law, there is a $5.49 million exclusion from federal estate tax, and a married couple can combine the exclusions to result in almost $11 million passing to heirs free of estate tax. Consequently, the only persons who would benefit from repeal are families of the very rich. What is potentially troubling is that the repeal of the federal estate tax could be coupled with a change in the current step-up in basis provision, which revalues assets at death. The repeal of the step-up rule could result in many more people paying income tax on inherited property than under current law.

BUSINESS TAX PROVISIONS

1. **Corporate Tax Rate**. The proposal reduces the highest corporate tax rate from 35% to 20%.

Observation. This provision has a high likelihood of passage. Both parties have expressed concern that the high corporate tax rate impedes domestic business growth. You can expect a compromise rate of perhaps 25% to be implemented.

1. **Lower Pass-Through Rate**. Owners of pass-through business organizations (sole proprietorships, partnerships and "S" corporations) that qualify as small and family-owned would be afforded the benefit of a maximum 25% tax rate on net income. Professional organizations, such as those for lawyers, doctors, and other professionals, would probably not be eligible.

Observation. The criteria of who should qualify for this benefit are unclear. Why should a wage earner be taxed at a maximum of 35% and a business owner at 25%? The provision could be complicated to administer.

1. **Expensing Capital Investments**. The proposal allows capital investments, with the exception of structures, to be immediately expensed versus depreciated over a period of years.

Observation. This could be an enormous incentive for business investment but also costly in terms of loss of tax revenue.

1. **Tax Credits and Specialized Deductions**. The proposal limits the net interest expense deduction for regular "C" corporations and may limit interest deductions for non-corporate taxpayers. Other deductions for specialized industries such as oil production will be scrutinized and possibly eliminated.

Observation. Limiting deductions and eliminating corporate benefits is one way to help offset the loss of revenue from tax reductions, but industry lobbyists will push hard to keep them.

1. **International Businesses**. The proposed law targets the current provisions that enable U.S. corporations to park foreign earned income offshore without current taxation. It will require the repatriation of accumulated foreign earnings subjecting it to tax. Payment of the tax will be spread over several years.

Observation. Requiring U.S. corporations to repatriate income held overseas could produce an enormous amount of tax revenue during the repatriation period that could help offset some of the other reductions in the tax bill. Similar efforts to encourage repatriation of foreign earned income have been made before with significant production of revenue.

PLANNING FOR TAX LAW CHANGES

At this point, it is enormously difficult to plan for possible changes in the tax code based on the Administration's proposals. I would compare the forecasting of this legislation to tracking a hurricane in the far reaches of the Atlantic. The storm could develop and be harmful to certain individuals and businesses or it could go out to sea. I think it is highly unlikely it could be enacted with an effective date in 2017. Parts of it could be implemented to go into effect in 2018. Certain provisions may be phased in over a number of years. I would therefore advise taking the deductions that are targeted for repeal so long as you can realize the benefit from them this year. Consider the present impact of the Alternative Minimum Tax. Whenever feasible keep your options open as long as possible with regard to business decisions. It may be prudent for businesses, especially "C" corporations, to put off the recognition of income until 2018, when tax benefits could be greater. Stay tuned for last minute Congressional Committee changes.

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