Current Federal Tax Developments

Nichols Patrick CPE a Division of the Loscalzo Institute

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SECTION: TAX REFORM

FRAMEWORK FOR TAX REFORM RELEASED BY BIG 6

Citation: "Unified Framework for Fixing Our Broken Tax Code", House Ways & Means Committee Website, 9/27/17

On September 27, 2017 the "Big Six" released the "*Unified Framework for Fixing Our Broken Tax Code*" that contained some details on the proposal. The framework, which runs for 9 pages, is a bit more detailed than earlier statements, but still omits many details necessary to determine the impact of the proposal on specific taxpayers. The first three pages of the framework contain mainly a vague description of the goals and justifications for the program, with only the final six pages giving actual information about steps to be taken.

By contrast, the initial proposal issued by the Treasury Department during the Reagan Administration that began the process the resulted in the Tax Reform Act of 1986 ran for over 400 pages.

Care must be taken when attempting to apply this proposal to a specific client situation. First, a lot of additional provisions will need to be added to the bill, the specifics of which likely will have dramatic impacts on various clients. Second, this is a work in process so that even the details contained in this document may end up being modified significantly in a process that leads to a bill that is able to garner the votes needed in Congress.

With those caveats, here are the items we know from the September 27 framework.

STANDARD DEDUCTION AND PERSONAL EXEMPTIONS

The new law will increase the standard deduction for single taxpayers and those filing married filing separately.

Filing Status	Current Law	September 27 Framework
Single	$6,350	$12,000
Married Filing Jointly	$12,700	$24,000

The framework does not contain information about the standard deduction for those filing head of household ($9,350 under current law), nor does it indicate if there will continue to be an additional standard deduction for those over age 65 and/or those who are blind ($1,250 or $1,550 depending on filing status).

While that represents a potential near doubling of the standard deduction, the framework would also eliminate the personal exemptions for the taxpayers. Thus, the net increase in the effective "zero tax bracket" (to borrow a term from the framework document) is significantly less than the increase in the standard deduction.

The following table reflects the calculation of the amount of this "zero tax bracket" under both current law and under the framework.

Single Taxpayer	Current Law	September 27 Framework
Standard Deduction	$ 6,350	$ 12,000
Personal Exemption	4,050	0
Total "Zero Tax Bracket"	$ 10,400	$ 12,000

That results in a slightly more than 15% increase in that zero tax level of income

Married Taxpayers Filing a Joint Return	Current Law	September 27 Framework
Standard Deduction	$ 12,700	$ 24,000
Personal Exemption	8,100	0
Total "Zero Tax Bracket"	$ 20,800	$ 24,000

This again results in slightly more than a 15% increase in the zero tax level of income.

Exemptions for dependents would also be eliminated under this proposal. The proposals seeks to replace the exemptions with an expanded child tax credit, along with a brand new $500 nonrefundable credit for each dependent other than a child.

The child tax credit will be phased out at a higher level of income than it is under current law. However, neither the amount of that increase before phase-out begins, nor the amount of increase in the child tax credit is specified in the framework.

The framework also promises the tax writing committees will "work on additional measures to meaningfully reduce the tax burden on the middle-class."

INDIVIDUAL TAX BRACKETS

The law would replace the current seven tax brackets with either three or four tax brackets.

- Current law tax individual tax brackets: 10%, 15%, 25%, 28%, 33%, 35%, 39.6%
- Proposed tax brackets: 12%, 25%, 35%, possible higher bracket

The fourth tax bracket, that would be greater than 35%, would be added to the law if it was determined to be necessary to insure the reformed tax code is "at least as progressive" as the current tax law and to keep the new law from shifting "the tax burden from high-income to lower- and middle-income taxpayers."

The framework also proposes to change the method of computing the inflation adjustments in the IRC to "a more accurate measure of inflation."

ALTERNATIVE MINIMUM TAX

The framework would repeal both the individual and corporate alternative minimum tax.

ITEMIZED DEDUCTIONS

Most individual itemized would be eliminated. However, the framework provides that both the home mortgage interest deduction and the charitable contribution deductions would be retained.

The language of this part of the framework does not specifically tell us which itemized deductions would be covered by the "most" modifier, aside from giving assurance that the mortgage interest and charitable deductions are not in that category. Deductions potentially subject to elimination would therefore include:

- State and local income taxes
- Real property taxes (not incurred on business or rental property)
- State and local sales taxes
- Medical deductions
- Investment interest expense
- Casualty and theft losses
- Investment expenses
- Employee business expenses
- Tax return preparation and tax planning fees (not related to a trade or business or a rental)

One item not found in the framework is any mention of lowering the amount of home mortgage debt on which interest could be claimed from the current caps. There had been speculation that reducing that deduction at the upper end would be one of the proposed changes.

Combined with the higher standard deduction amount, fewer taxpayers would now be itemizing deductions. As well, advisers must remember that the taxpayers who itemize will also no longer have any benefit from their personal exemptions, since those are essentially "folded into" the standard deduction.

WORK, EDUCATION AND RETIREMENT

The framework contains rather vague language related to these areas. As the framework provides:

> *The framework retains tax benefits that encourage work, higher education and retirement security. The committees are encouraged to simplify these benefits to improve their efficiency and effectiveness. Tax reform will aim to maintain or raise retirement plan participation of workers and the resources available for retirement.*

Similarly the framework makes a broad promise to repeal many of the other "exemptions, deductions and credits for individuals" that "riddle the tax code."

ESTATE TAX

The framework provides that the estate tax and the generation skipping transfer tax would be repealed.

BUSINESS TAX RATES

The proposal would lower the corporate tax rate to 20%, as well as considering ways to reduce the double taxation of corporate earnings. No mention is made of whether the law would retain a special higher rate for personal service corporations.

The maximum rate for "business income" for small and family owned businesses conducted as sole proprietorships, partnerships and S corporations would be set at 25%. But the framework would contain anti-abuse measures to "prevent wealthy individuals from avoiding the top personal rate."

Key items advisers will need to watch as such a small business special rate system is written include:

- How will the law determine what is a qualifying "small and family owned business" that qualifies for this rate
- The definition of "business income" that qualifies for the maximum 25% rate
- What Congress views an "abuse" by individuals and the provisions that are imposed to deal with attempts to convert income to 25% income
- Will a portion of the earnings from a qualified entity be treated as "earned income" not eligible for the lower rate (that is, it would be the amount for the services of the owner vs. "business income" that arises from the investment in the business by the owner.)

EXPENSING OF CAPITAL IMPROVEMENTS

The law would allow for the immediate deduction against income any new investments in depreciable assets other than structures made after September 27, 2017. However, the framework then provides that this will likely be a temporary provision, providing this expensing will exist for "at least" five years.

Note that this may not be a very big deal for small businesses unless the business purchases more than $500,000 of equipment, since IRC §179 already allows expensing of such equipment for businesses that elect its use.

INTEREST EXPENSE

The framework provides that the deduction for net interest expense by C corporation will be "partially limited." As well, the tax writing committees are directed to consider the "appropriate treatment" of interest paid by non-corporate taxpayers.

This is an area where many more details are needed before any evaluation of the impact of this provision is possible. Per various reports during the development of this proposal, originally the loss of the net interest deduction entirely was to be the trade-off for getting immediate expensing of equipment purchases. However, significant opposition to this proposal arose from many quarters, resulting in this rather vague statement of what the plan now is with regard to such interest.

OTHER BUSINESS DEDUCTIONS AND CREDITS

The Section 199 domestic production deduction would be repealed under the framework, along with "numerous other special exclusions and deductions" that would either be repealed outright or restricted.

The framework does promise to preserve two credits, those for research and development and for low-income housing. The document goes on to note that the framework "envisions repeal of other business credits," other credits may be retained as "budgetary limitations allow."

OFFSHORE CORPORATE EARNINGS

The framework would revise the U.S. system for taxing a multinational U.S. corporation. The proposal would introduce a 100% deduction for dividends received from a foreign corporation if the receiving corporations holds a least a 10% interest in the foreign corporation.

As well, the U.S. would tax, at a reduced rate, the foreign profits of U.S. multinational corporations. There would be rules to "level the playing field" between U.S. headquartered companies and foreign headquartered parent companies.

To transition to this system an immediate repatriation of offshore earnings would be deemed to take place. The tax on this repatriation will be spread out over several years and a lower rate will be imposed on illiquid assets held overseas vs. cash and other liquid items.

PROSPECTS FOR THE FRAMEWORK

The House Ways and Means committee will apparently be the starting point for the drafting of actual legislation. Congressional leadership has decided to use the budget reconciliation process to pass this reform, which would allow the proposal to pass the Senate with only 50 votes (along with the tie-breaking vote of Vice-President Pence). However, there are issues with using reconciliation to accomplish this process.

The biggest problem is that, per the rules that govern reconciliation in the Senate, the bill cannot result in increased deficits more than ten years out. Due to this, it is very possible that many or all of the changes may be set to sunset 10 years out, creating another future fiscal cliff.

As well, the reconciliation instructions that authorized this bill only allow the bill to increase the deficits during the 10 year period by no more than $1.5 trillion dollars. Reports had indicated that the total "cost" of the tax reduction provisions that were to be in the framework were estimated at $5 trillion if immediately implemented, meaning a good portion of that expense either needs to be paid for with "revenue offsets" (what most of us would view as tax increases) or the benefit phased-in over time (as we saw with the long slow march to estate tax repeal under EGTRRA when it was passed under the same mechanism in 2001).

The good news/bad news for the Congressional leadership is that, by using reconciliation, the bill can be passed with only Republican votes, eliminating the need to include provisions to entice a significant number of Democrats to vote for the bill that they would prefer not to include (they would need 60 votes).

But the downside of that is, given the narrow Republican majority in the Senate, this only works if the Republicans can bring forward a tax reform bill that has virtually unanimous support in their caucus—something they were unable to do when they attempted to use reconciliation in the prior budget year to pass the repeal/replace of the Affordable Care Act. Only 2 Republican Senators can vote against the final proposal without requiring the Leadership to cut a deal with Democrats or fail to enact a second major legislative initiative.