

Larry's Tax Law

## Tackling Tax Reform – Part IV: What Can We Expect To See

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On April 11, 2017, we discussed [what constitutes Tax Reform](#). On April 24, 2017, we explored [the process](#) by which Tax Reform will likely be created by lawmakers. In our May 3, 2017 blog post, we focused on the likely [timing](#) for Tax Reform. In this blog post, we look at what Tax reform may look like.

Like one of my favorite things in this world, namely ice cream, Tax Reform also likely comes in different flavors. For starters, we have President Trump's campaign comments on Tax Reform. Next, we have the Republican leaders' from the U.S. House of Representatives initial draft of a Tax Reform package. Lastly, we have the White House's April 26, 2017 one-page memorandum that broadly outlines the President's current vision of Tax Reform.

Let's break Tax Reform into three broad categories, namely:

1. Estate & Gift Tax
2. Individual Income Tax
3. Corporate Income Tax

### **ESTATE AND GIFT TAX**

Now, let's look through my crystal ball to see what is in store for our Estate and Gift Tax laws under Tax Reform.

Both the President and the House Republican leaders have been floating their ideas on what should happen to our Estate and Gift Tax system. The President's original plan called for the complete repeal of the Estate and Gift Tax laws. In its place, however, President Trump proposed an income tax. The new income tax would be triggered by a fictitious sale of the decedent's assets, which is deemed to occur at the taxpayer's death. This is similar to the Canadian system. Ten million dollars of assets (valued at death) would be excluded from the tax. Any appreciated assets contributed to a private charity within three years of death would be pulled back into the taxpayer's estate and this income tax would be applied.

**EXAMPLE 1:** Assume taxpayer Jones dies with \$9 million of assets at death and a basis of \$1 million in those assets. Taxpayer Jones escapes the President's proposed tax altogether because the value of his estate was under \$10 million.

**EXAMPLE 2:** If taxpayer Jones died, however, with \$21 million, the Jones estate would be faced with a tax of approximately \$3.3 million [ $\$21 \text{ million} - \$10 \text{ million exemption} \times 33\% = \$3.3 \text{ million}$ ].

The President's original death tax proposal leaves at least four unanswered questions, namely:

1. Will certain types of assets be excluded from the tax, and if so, what are those assets?
2. Are death transfers to spouse's excluded from the tax?
3. Is the \$10 million portable (if it is not used by the decedent, can the surviving spouse, if any, use the remainder on his or her death)?
4. Do the heirs of a decedent get a carry-over basis in the assets inherited or do they get a fair market value basis in the assets inherited?

The House Republican leaders published a discussion draft of a Tax Reform bill. In that proposed legislation, the current Estate and Gift Tax laws are simply repealed. Unlike, the President's initial plan, no income tax is planned to replace the repealed tax.

So, in both of our taxpayer Jones examples above, no tax would be due on the death of Jones.

Like President Trump's initial proposal, the House proposal is silent on whether assets of a decedent will be stepped up to fair market value upon death or whether the heirs receive the assets with a carry-over basis.

In the President's April 26 memorandum entitled "2017 Tax Reform for Economic Growth and America Jobs," he simply states that there shall be a complete repeal of the "death tax." Unlike his campaign statements, he does not talk about replacing it with an income tax. Further, he does not even address the gift tax. Also, his brief memorandum fails to touch upon the many issues that follow a repeal of the estate tax (e.g., whether there will be any sort of replacement tax; how the basis of inherited assets will be handled).

## INDIVIDUAL INCOME TAX

Let's look at some of the income tax provisions contained in the President's original campaign proposal, the House's Tax Reform proposal and the White House's April 26 one-page memorandum.

### Tax Rates

Both President Trump during his campaign and the House Republican leaders propose to eliminate the top individual income tax rate, which is currently 39.6%. They also propose to collapse the other brackets, currently 10%, 15%, 25%, 28%, 33%, and 35%, to three brackets, namely 12%, 15% and 33%. So, the top individual rate would be 33% under both proposals. It appears, President Trump's one-page memorandum dated April 26 reflects this same proposal. President Trump states: he will "[reduce] the seven tax brackets to three brackets of 10%, 25% and 35%." President Trump's April 26 alert does not say, however, whether we will end up with three brackets of precisely 12%, 15% and 33%.

### **Itemized Deductions**

Both the House and the President's campaign proposal provide a change in the way we treat itemized deductions.

President Trump proposed a cap be placed on itemized deductions. The cap would be \$200,000 married couples filing jointly and \$100,000 for single filers.

The House proposal is a bit more drastic. It proposes, with two exceptions, itemized deductions be eliminated altogether. The exceptions are: (1) home mortgage interest; and (2) charitable contributions.

Under either proposal, taxpayers with large income tax, sales tax, and mortgage interest obligations will get hurt.

Under the President's original proposal, charities will surely get hurt. Given the lobbying power of charities, I suspect the White House will modify the President's proposal to carve out charitable contributions.

The White House's April 26 memorandum does not address itemized deductions. So, it is anyone's guess whether President has re-thought his campaign proposal on this topic. He does say in the memorandum that he plans to "[e]liminate targeted tax breaks that mainly benefit the wealthiest taxpayers." Does he mean to include "itemized deductions" in this statement? Time will tell. **CAVEAT:** The memorandum does expressly state that: "home ownership and charitable gift tax deductions" will be protected.

### **Standard Deduction**

Both the House and the President's original proposal includes changing the way we treat the standard deduction and personal exemptions.

President Trump originally proposed that the standard deduction be increased from \$6,350 for single filers to \$15,000, and from \$12,700 for married couples to \$30,000. In addition, he

originally proposed that the personal exemption (which is currently \$4,050) be eliminated altogether. In his April 26 memorandum, President Trump now states that the standard deduction will be “doubled.” This is a slight retreat from his campaign proposal. The memorandum does not expressly address the personal exemption.

The House proposal provides that the personal exemption and the standard deduction be consolidated into a single deduction (\$12,000 for single filers and \$24,000 for married filers).

#### **Obamacare Tax**

Both of President Trump’s proposals (campaign and post-election), and the House proposal provide for the repeal of the 3.8% Net Investment Income Tax.

#### **Individual Alternative Minimum Tax**

Both of President Trump’s proposals (campaign and post-election), and the House proposal provide for the repeal of the individual alternative minimum tax.

#### **Capital Gains Rates**

President Trump’s original proposal was to leave the top level of the capital gains tax at 20%. The House, however, proposes to eliminate the preferential capital gains tax rates and replace them with a 50% deduction for capital gains, dividends and interest income. So, in practice, under the House proposal, capital gains, dividends and interest income would be taxed at one half of a taxpayer’s applicable ordinary income tax rate. That results in a tax rate for these items equal to 6%, 12.5% or 16.5%, depending upon a taxpayer’s tax bracket. It appears the President has not changed his mind on the capital gains rates as his April 26 memorandum fails to even mention this subject. Consequently, it appears he is proposing to leave the capital rates unchanged.

### **BUSINESS TAXES**

Let’s turn our attention to the business tax proposals. Both President Trump and the House propose several changes in this area.

#### **Corporate Tax Rates**

President Trump originally proposed to eliminate the current corporate tax bracket rate structure for C corporations, which ranges from 15% to 35%, and replace it with a one-size-fits-all tax rate of 15%. The House offers a similar concept, but its proposed rate is 20% (rather than 15%). President Trump’s April 26 memorandum stays with the 15% rate.

#### **Special Pass-Through Tax Rate**

The President's campaign proposal included a flat 15% rate for pass-through entities that retain profits within the business entity rather than at the rates of the entity owners (which is what we have under current law). The House follows President Trump's proposal, except that it proposes a flat 25% rate. Under both the President and the House's proposal, to be eligible for the preferential tax rate, the entity must pay its owners reasonable compensation (taxed at the normal individual rates). The White House's April 26 memorandum does not mention the special pass-through rate. So, it is unclear whether President Trump has abandoned this concept.

### **Corporate Alternative Minimum Tax**

Both of President Trump's proposals (campaign and post-election), and the House proposal provide for the repeal of the corporate alternative minimum tax.

### **Special Rules for Manufacturers**

President Trump originally proposed to allow manufacturers to elect to expense capital investments. Manufacturers making the election, however, would be required to forego any deduction for business interest. While the President's original plan appears to focus on manufacturers, the House plan allows all trades or businesses to expense the cost of tangible property used in a trade or business, including equipment and buildings (but excluding land). In addition, these businesses would be allowed to deduct any interest expense against interest income, with any excess carried forward indefinitely. President Trump's April 26 memorandum is void of any discussion relative about any expensing of capital expenditures. So, it is not clear whether he has abandoned his original campaign thoughts on capital expenditures.

### **Carried Interest**

The President's original proposal contained a provision on carried interest. **Carried interest** is a share of any profits that the general partners (the professional managers) of private equity and hedge funds receive as compensation, regardless of whether or not they contributed any initial funds. Under current law, carried interest is taxed at capital gains rates. The President, however, in his original Tax Reform proposal, expressed his desire to tax carried interest at ordinary income rates.

Both the President's memorandum and the House proposal are silent on the treatment of carried interest. So, it appears that the House and now President Trump (per the silence in his April 26 memorandum) intend to leave the law as is and continue to allow carried interest to be taxed at capital gains rates.

### **Overseas Earnings**

A big issue over the last decade is the more than \$3 trillion of untaxed offshore corporate income. Under the current law, unless it is repatriated to the United States, it will remain untaxed by our country. The President originally proposed during his campaign to tax these untaxed dollars currently at 10%, regardless of whether the money is repatriated. The tax would be due immediately upon the passage of the President's Tax Reform bill. In his April 26 memorandum, however, he makes a broad sweeping statement: “[he will place a] [o]ne-time tax on trillions of dollars held overseas.” President Trump offers no specific guidance as to what tax rate applies or when the tax would be due and payable.

The House, on the other hand, proposes to tax these untaxed dollars at a rate of 8.75% (to the extent the funds are held in cash or cash equivalents) or 3.5% (to the extent the funds are not held in cash or cash equivalents). The tax would be payable over eight years.

### **Territorial Tax System**

During the President's campaign, he talked about repealing the Code provisions that allow any deferral of foreign profits for U.S. companies going forward. His written campaign proposal, however, is silent on the issue. It is not clear whether he intends to only currently tax non-patriated foreign profits accumulated from past business activities or whether he also intends to tax non-patriated foreign profits on a go-forward basis. If he does not intend to tax non-patriated foreign profits on a go-forward basis, we will be back in the same situation with trillions of dollars being earned and left overseas down the road that are free of U.S. income tax.

The House proposes a territorial tax system to deal with the issue with profits being retained overseas going forward. Under such a system, income is taxed where it is earned; it is not taxed when it is repatriated to the county of its foreign parent. So, the potential tax deferral of foreign profits would continue. To alleviate this problem, however, the House also proposes a border adjustability tax. Under such a regime:

1. A U.S. company would not pay tax on goods it sells outside the United States (likewise, it would not get a deduction for its cost of the goods sold outside of the United States); and
2. A U.S. company that buys goods from outside the United States and sells the goods within the United States, would pay tax on the income from the sale, but it would not get a deduction for the cost of foreign goods sold in the United States.

It remains unclear whether the House proposal complies with the World Trade Organization's rules.

President Trump's April 26 memorandum, unlike his campaign talk, provides that he is now favoring a “[t]erritorial tax system to level the playing field for American companies.” The memorandum does not tell us whether he is suggesting the House territorial and border

adjustability tax proposal be adopted.

### **Global Changes**

Last, President Trump's memorandum broadly states that, as part of business Tax Reform, he intends to "[e]liminate tax breaks for special interests." Unfortunately, he does not offer us any details about what provisions of the Code will be impacted.

### **CONCLUSION**

So, here we are – we have the President's campaign discussion about Tax Reform, the House Republican leaders' first draft of a Tax Reform proposal, and the White House's one-page summary of what Tax Reform should entail. In addition, the President tells us that his administration will be meeting with stakeholders during the month of May to get us closer to a Tax Reform bill. As alluded to above in this blog post, a lot more detail has to be explored before any Tax Reform bill will be ready to introduce to lawmakers. Also, as discussed in my April 24 blog post, even with a Republican controlled House and Senate, getting any Tax Reform legislation passed by both the House and the Senate will be a tremendous task. Time will tell. Stay tuned!

**Tags:** Congress, corporate income tax, estate & gift tax, Individual Income Tax, President Trump, Republicans, Tax Reform, Tax Reform Package