President Trump Outlines Tax Reform Proposal

Cut in business & personal tax rates, changes to deductions highlight plan

Following up on one of his major campaign promises, President Donald Trump provided an outline of his latest tax reform proposals in a series of statements and releases. The only information provided in writing at this point is a one-page summary, with no actual legislation created so far. As a result, there are many unknowns, as well as significant room for future negotiation with Congress.

This proposal addresses many of the broad themes he highlighted during the campaign, such as lowering the tax rate on businesses – both corporations and pass-through entities – and a consolidation of the individual tax rates. The outline also includes significant changes to how taxpayers would offset taxable income by eliminating most types of itemized deductions while greatly expanding the standard deduction. Along with proposing a repeal of the Alternative Minimum Tax, this proposal would likely create a less complex tax system, although the net impact on taxpayers is unknown at this point. The President has said more details will be released in the coming weeks, while the full budget proposal might not be available until June.

Below are explanations of provisions that were included in both the outline and in subsequent comments from White House officials, along with some of the unknown issues yet to be resolved.

Consolidation of Individual Tax Brackets

One of the biggest proposals included in this plan would be a consolidation of the individual income tax brackets, going from seven brackets today to just three – 10%, 25% and 35%. This is similar to the system President Trump had proposed during the campaign, although this new proposal includes a slightly larger gap between the top and bottom rates.

<u>Unanswered Questions</u>

- The main question here is what income levels would apply at each rate. By assuming that income wouldn't be taxed at a higher rate than it is currently, the current tax brackets can be easily mapped over to these new rates:

Current 2017 Brackets			Potential New Brackets		
Rate	**Married Filing Joint**	**Single**	**Rate**	**Married Filing Joint**	**Single**
10%	Up to $18,650	Up to 9,325	10%	$0 – 75,900	$0 – 37,950
15%	$18,650 – 75,900	$9,325 – 37,950			
25%	$75,900 – 153,100	$37,950 – 91,900	25%	$75,900 – 416,700	$37,950 - $416,700
28%	$153,100 -233,350	$91,900 – 191,650			
33%	$233,350 - 416,700	$191,650 – 416,700			
35%	$416,700 – 470,700	$416,700 – 418,400	35%	$416,700+	$416,700+
39.6%	$470,700+	$418,400+			

- Using these three brackets might not provide enough of a tax cut for middle class taxpayers, so it's possible those brackets could be shifted.
- The subject of capital gain rates was not addressed in any of the released materials, but presumably the current three tier system - 0%, 15% and 20% - would continue to apply. The breakpoint for those rates could match the new ordinary tax brackets, or a new set of brackets could be created.

Changes to Itemized Deductions, Standard Deduction

This proposal would nearly double the current standard deduction, from $12,700 in 2017 to $24,000 for married couples and from $6,350 to $12,000 for singles. In addition, all itemized deductions other than mortgage interest and charitable contributions would be eliminated. This would include the deduction for state and local income and property taxes, which the President views as a subsidy for high tax rates imposed by some states. Among other deductions lost would be those for medical expenses, investment interest expense, casualty losses and those expenses classified as "miscellaneous deductions". After some initial confusion, however, the White House confirmed that deductions for retirement plan contributions would not be eliminated.

This combination of a larger standard deduction and fewer itemized deductions would greatly simplify tax preparation, while also eliminating the need to file for many more taxpayers.

Unanswered Questions

- During the campaign the President vowed to eliminate personal exemptions, the $4,050 taxpayers can deduct in 2017 for themselves and any dependents. These were not addressed in this outline.
- President Trump had also suggested during the campaign that itemized deductions should be capped at $200,000 for couples and $100,000 for singles. Those limits were also excluded in this outline.
- There was no mention of the Pease Limitation, the phaseout of itemized deductions that applies to couples with income over $313,800 (singles over $261,500) in 2017. Presumably that would continue to apply.
- There was also no mention of those deductions considered "above the line", such as alimony payments, contributions to Traditional and SEP IRAs and Health Savings Accounts, college tuition and moving expenses. It would appear that some of those would remain, while others would be repealed.

Reduced Corporate Tax Rate

Another of President Trump's signature campaign promises was to lower the income tax rate paid by corporations. This latest proposal includes a plan to lower that rate from effectively 35% to 15%. This lower rate would also apply to pass-through entities, such as Partnerships and S Corporations. The income from these entities is currently taxed to their owners, meaning a tax rate as high as 39.6%.

Unanswered Questions

- The original campaign proposal included this 15% rate, but it also said that any distributions from pass-through entities to the owners would be taxed again, perhaps as a dividend. That was not addressed in the current proposal.

- This lower tax rate would incent pass-through owners to avoid realizing compensation income (which is taxed at ordinary tax rates) and instead treat all income as business income. In order to prevent abuses, the final law would include as-yet unknown provisions addressing this.
- None of the proposals on this topic have made any distinction between active business interests and passive investments. If this lower rate did apply to passive investments, then Master Limited Partnership interests would become more attractive. The same could also be true for rental properties held in an LLC.
- The latest proposal included a plan to "eliminate tax breaks for special interests", but with no clarification. This could mean an elimination of certain deductions or credits for corporate (or even individual) taxpayers.

Repeal of the Estate Tax

Without any explanation, the proposal states a desire to repeal the estate tax. For 2017, the estate tax rate is 40% on taxable estates over $5.49 million.

Unanswered Questions

- The proposal made no mention of related items such as the gift tax or generation skipping tax. Their future is uncertain, although some past proposals to repeal the estate tax also repealed these two taxes.
- Most past estate tax repeal proposals have included changes to the basis adjustment at death rules. This outline did not include such a reference. Presumably some form of carryover basis would apply, with estates under a certain threshold receiving a full basis adjustment.

Repeal of the Alternative Minimum Tax

In another form of tax simplification, not to mention a tax cut for many taxpayers, the outline includes the repeal of the Alternative Minimum Tax. The Trump administration has said repealing this tax would prevent many taxpayers from having to calculate their tax liability twice.

Unanswered Questions

- Taxpayers who have paid AMT in prior years can, in many cases, recover that extra tax via the AMT credit. If the AMT were to be repealed, the ability to still utilize that credit would be uncertain.

Other Provisions Included in the Outline

In addition to the primary items listed above, the tax reform outline included the following items:

- Repeal of Net Investment Income Tax – The Patient Protection & Affordable Care Act included multiple taxes to help fund the cost of the new government-supported health system. This proposal would repeal one of those taxes – the 3.8% tax on investment income, including dividends, capital gains, rental income, etc. The future of other taxes in the bill, such as the additional 0.9% Medicare tax on earned income and the tax on high-value health care plans, were not addressed in the proposal, not to mention the future of the PPACA in general.

- International Tax Provisions – The outline refers to a one-time tax on repatriated profits currently being held overseas, although it does not state a specific tax rate. The US would also move to a territorial tax system from a worldwide system, meaning businesses would only pay on income earned in the US.

Next Steps

The administration has said the goal is complete this tax reform work this year, but has not committed to an effective date for any of the proposals. While it's certainly possible these items could all be made retroactive to the beginning of 2017, delaying the implementation to 2018 seems a more likely approach.

In order to ease the passage of any reform package, the administration would likely move this bill under the budget reconciliation rules. This allows the bill to pass the Senate with a simple majority, meaning Republicans could pass the bill without any support from Democrats. This approach, however, means none of the provisions can lead to an increase in the budget deficit beyond 10 years, a target that is unlikely to be met given the significant tax cuts included. In prior legislation, this has been addressed by scheduling all the provisions to be repealed after year 10, and that approach could be taken again with this bill.