2017-2018-year Tax Reform Plan

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(Sources: www.donaldtrump.com)
https://waysandmeansforms.house.gov/uploadedfiles/tax_framework.pdf

By Cameron L. Hess

The election of a new president creates the anticipation of major tax changes. While tax law changes, were initially identified during President Donald Trump's campaign, under discussion are possible revisions to the September 27, 2017 Tax Reform Framework by the House Ways and Means Committee and several competing proposals by key Republicans.

The House passage today 216-212 of the $4 Trillian US Budget, approved by the Senate last week, is not the Prposed Tax Plan.[1] To understand the process, keep in mind that the fine tuning has not occurred – and what is fine tuning to Congress can mean major changes to taxpayers. The Senate Finance Committee has not had its say, and it tends to be the "polishing agent" with final say in the Joint Conference Committee. Approval will likely follow party lines, 51-49 in the Senate, which means that all changes will likely have a 10-year expiration date, to avoid the Byrd Rule[2] requiring support of 60 senators to avoid a filibuster. In addition, expect that the tax reductions will increase the U.S. budget deficit greater than anything seen during the prior 8-year. Estimates range from 1.5 to 10 trillion. Republican Senator Bob Corker opposition to deficit spending and a history of advocating balanced budget notwithstanding, including the Republican Platform in 2017,[3] and the 2012-year proposed Balanced Budget Amendment, in practice, the party has the record of greater give-away and economic overheating of business cycles to garner votes and short-term gain.

The following summary highlights some of the more significant proposed changes:

Individual Income Tax

Tax rates

[1] Massive cuts are made to Medicare over 10 years and more than $1 trillion from Medicaid. States get to decide who gets "cut" or has reduced services. Domestic departments with largest cuts: agriculture, transportation and energy. While reported as a balanced budget, the actual records may differ. (http://dailysignal.com/2015/05/02/the-truth-about-gop-budgets-they-never-balance/)

[2] The Byrd Rule is a Senate rule that amends the Congressional Budget Act of 1974 to allow Senators, during the Reconciliation Process, to block a piece of legislation if it purports significantly to increase the federal deficit beyond a ten-year term or is otherwise an "extraneous matter" as set forth in the Budget Act. It is named after West Virginia Senator Robert Byrd.

[3] The Platform States: "*Our national debt is a burden on our economy and families….We must impose firm caps on future debt, accelerate the repayment of the trillions we now owe….and remove the burdens we are placing on future generations" (Platform, July 18, 2016)*

The Trump Plan will collapse the current seven personal income tax brackets down to just three tax brackets. The tax rates and breakpoints for each bracket that Trump proposed are shown below. These tax brackets are similar to those under the House GOP tax blueprint.

Brackets and Rates for Married-Joint filers:
Less than $75,000: 12%
More than $75,000 but less than $225,000: 25%
More than $225,000: 33%
*Brackets for single filers are ½ of these amounts

In addition, the Trump Plan proposes to retain the existing capital gains rate structure (maximum rate of 20 percent.)

However, the sale of a carried interest will be taxed as ordinary income. Carried interest represents owner profit/loss interests in pass-through entities granted to developers/promotors for services and not for cash or property. Because this will increase the effective tax rate on real estate developers/promotors when they sell their interests (including Donald Trump), expect to see ever more sophisticated tax avoidance schemes by real estate developers/promoters and IRS challenges making the news. Also uncertain is the treatment of interests inherited by the developer/promotor's children (Trump's Children.)

Net Investment Income Tax/Alternative Minimum Tax. In addition, Trump's Plan proposes the repeal of the 3.8 percent tax on net investment income and the repeal of alternative minimum tax. However, in January I predicted that it would be unlikely to see the repeal of both the 3.8% NIIT and AMT together. This was in part due to the substantial loss of tax revenue.

The present direction seems to be that the 3.8% NIIT may remain in place. As to a repeal of alternative minimum tax – which often hits moderate to high-income taxpayers, a possible course of action would be for Congress to retain, but make changes to alternative minimum tax increase the AMT exemption amount or may eliminate certain add-backs to taxable income or allow credits.

The other course of action is to eliminate AMT, but make the tax structure similar to the current laws for AMT. This is discussed below.

Deductions

Standard Deduction. There are modest differences between the Trump Plan and the Framework. The latest is to increase the standard deduction for joint filers to **$24,000** (from $12,600), and the standard deduction for single filers to $12,000. (Trump Plan proposes $30,000 and $15,000.)

Eliminated. The deduction for personal exemptions, based on the filers and children is proposed to be eliminated. Compared to current law, certain very high income taxpayers are already subject to phase-out of their personal exemptions, and do not receive any.

Also at risk is the elimination of head-of-household filing status. While politically, no statements are being made against unmarried persons with dependent children, this does not mean that from a tax policy perspective, the status of being unmarried can be discouraged by having them pay greater taxes. Head of household status is intended to benefit unmarried persons who have one or more dependents to support, by providing reduced taxes.

Child Care Deduction/Credit. Expect to see a proposed increase in the child care deduction or credit. The proposal is increase an amount as an above-the-line deduction for child care expenses incurred enabling one to work. Present law also encourages continuing education by deeming earned income when attending college full-time.

Third Rail Issues. While not directly part of the Trump Proposal, Congress has been discussing whether to eliminate or limit the deduction of taxes as an itemized deduction. As a hot issue, Donald Trump has publically stated he will not support that, which is a safe move to support Republications in high tax states. As a compromise, expect to see a limit on the amount of taxes that are deductible. For example, there may be the elimination of property taxes paid on a second home.

A related issue is discussion of eliminating the deduction of interest expense paid on a home. Expect that this will be opposed by the home construction industry, which is already limited to the $1 million acquisition indebtedness plus $100,000 home equity line of credit. As inflation eats into this fixed allowance (there is no CPI indexing), the current law is already beginning to limit a greater number of individuals each year with respect to their home interest deduction.

Itemized Deductions Cap. The Trump Plan proposes to "cap" total allowable itemized deductions at $200,000 for Married-Joint filers or $100,000 for Single filers. The Framework proposes to eliminate most itemized deductions (i.e., medical deduction, casualty, employee/tax expenses), but retain home mortgage interest and charitable deductions.

Interestingly, the elimination of the casualty deduction involves bad timing. With losses due to fire and hurricane, Congress may have a difficult time eliminating this deduction which is already severely limited by a requirement that the loss must exceed 10% of AGI (as well as loping off $100.00)

Death Taxes

The Trump Plan will repeal estate taxes on death, but replace it with a capital gains tax on estates over $10 million.

Estate Taxes began during the Civil War, ending 1875, and during World War I, in 1918. Certain current benefits allowed for small businesses and family farms will likely continue or be expanded.

As a partial revenue offset, there will likely be imposed limitations on charitable contributions. Under the plan, individuals who at death make bequests to a private foundation will not be allowed a deduction from capital gains taxes.

Also, what is not discussed publically is that this proposal comes with a proposal to substitute the estate tax with a capital gains tax at death.

The actual effect of this change will not actually eliminate death taxes. Given that the maximum capital gains rate is 20 percent, it will simply cut the effective tax rate of death taxes by one-half.

Interestingly, there is already a model for this exact system of taxes. In particular, Canada already has a capital gains tax in lieu of estate taxes. In Canada, a death is treated as a deemed disposition. Canada has a low lifetime exclusion amount, $800,000 ($1 million for qualified farm/fishing property), both which are inflation indexed) However, because Canada does not have a reduced capital gains tax rate, but follows a 50% exclusion, that also reduces the benefit of the exclusion amount. As a result, Canada's tax, unlike the Trump proposal , presently generates significant tax revenue. Also significant is that Canada's tax discourages the use of irrevocable trusts for any long-term. Irrevocable trusts are subject to a deemed sale and re-taxing every 21-years. Gifts of real estate and other appreciated property are also taxed – making gift planning of real estate a significant issue. The Trump Plan proposes to continue the exclusion amount – using capital gains tax – at the current $5 million per person/$10 million per couple (currently indexed at $5,490,000 and $10,980,000)

One of the open questions is whether the revised proposal will continue the step-up at death with respect to tax basis. Tax attorneys have for decades identified that carry-over basis is unworkable, and was repealed after having been tried twice.

Another question is will this new law change the taxation of IRD items, such as installment sale notes, defined contribution plans and IRAs, when payments are received by heirs after the death of the note/account holder.

Presently these assets considered to be "income with respect to the decedent", i.e., IRD items, and are subject to the potential of both estate taxes at death and income taxes upon receipt of distributions/income. While currently, there is no "step-up" as to those items, recognizing gain on appreciation at death would seem to support eliminating the potential double taxation by allowing step-up in tax basis.

As a result of these changes, expect individuals with large estates who are charitably minded to ask about contributions of appreciated property to a charity to avoid gain recognition. The rules on such contributions are complex, however. For example, a contribution to a private foundation of real property has a severe deduction limitation, limited to essentially adjusted basis. A contribution of real property to a public charity that is not a private foundation is usually better treated – a fair market value deduction, but is subject to a 30% contribution base limitation. However, in either event, currently there is no capital gains taxation to anyone if the private foundation or public charity then sell the real property.

Childcare

The above-the-line deduction for the cost of childcare on behalf of children under age 13 is proposed to be enhanced. The Framework provides very little in details. However the Trump Plan suggested a deduction capped at state average costs for age of child, and for eldercare for a dependent. This deduction will not be available to taxpayers with total income over $500,000 Married-Joint /$250,000 Single.

This program is intended to focus on working, middle class families to provide a substantial reduction in their taxable income. The program is also intended to provide a broad benefit plan, and would include families who use other family members (e.g., stay-at-home parents or grandparents) as well as paid caregivers. The Trump Plan proposed that the deduction would be limited to 4 children per taxpayer. There would also be allowed an eldercare exclusion, capped at $5,000 per year. The cap would increase each year at the rate of inflation.

The Trump Plan would further offer spending rebates for childcare expenses to certain low-income taxpayers through the Earned Income Tax Credit (EITC). The rebate would be equal to 7.65 percent of remaining eligible childcare expenses, subject to a cap of half of the payroll taxes paid by the taxpayer (based on the lower-earning parent in a two-earner household).

This rebate would be available to married joint filers earning $62,400 ($31,200 for single taxpayers) or less. Limitations on costs eligible for exclusion and the number of beneficiaries would be the same as for the basic exclusion. The ceiling would increase with inflation each year.

The Plan also proposes that all taxpayers would be able to establish Dependent Care Savings Accounts (DCSAs) for the benefit of specific individuals, including unborn children. This proposal modifies the existing Coverdell Education Savings Accounts under Section 530 which already allows total annual contributions limited to $2,000 per year from all sources, but does not provide for unborn children as of yet. As with the existing plan, there is an account owner (parent in the case of a minor or the person establishing elder care account.) When established for children, the funds remaining in the account when the child reaches 18 can be used for education expenses, but additional contributions could not be made.

To encourage lower-income families to establish DCSAs for their children, as a change to the existing law, the federal government will provide a 50 percent match on parental contributions of up to $1,000 per year for these households. In addition, when parents fill out their taxes they can check a box to directly deposit any portion of their EITC into their Dependent Care Savings Account. As with existing Coverdell accounts, deposits and accumulated earnings will be free from taxation prior to distribution; unused balances can rollover from year to year.

401(k) Plans

The noise coming from Republican Representative Brady to kill the 401(k) plan is not going anywhere, and is probably opposed by most if not all elected Republican members.

Business Tax (Corporations)

Tax Rates. There is no consensus yet on corporate tax rates. The Trump Plan proposed a business tax rate on corporations of 15 percent, and eliminating the corporate alternative minimum tax. The Tax Reform Framework proposes a 20 percent rate and an across-the-board 24% rate of tax on the "business income" of small and family businesses, however organized – proprietor, partnership, or S Corporations.

The GOP House Republicans are ready to accept a corporate rate of 20% and a reduced rate on S Corporation income shareholders of 25 percent. This rate is available to all businesses, both small and large, that want to retain the profits within the business. Currently, Trump has indicated opposition to anything above a 20% rate.

Even with these lower rates, unless there is eliminated the taxation of corporations upon dissolution, and corporations are given more liberal shareholder "tax basis" rules, we continue to generally recommend for tax purposes against holding real estate in either a C Corporation or an S Corporation; that includes an LLC that has elected to be taxed as a Corporation.

Capital Investments Deduction (1st Year Write-Off). The Framework proposes from September 27, 2017 and continuing for 5-years, the write-off of all capital expenditures other than buildings and other structures. This would replace Section 179, which presently allows a large write-off of capital expenditures for small businesses.

Corporate Interest Expense. The Framework proposes eliminating corporate interest expense and "appropriate treatment" of interest by non-corporate taxpayers. This proposal will likely not pass because it would essentially freeze out the use of debt capital. However, there is a possibility that certain types of leveraged financing to acquire companies will be discouraged – rather than a simplification – there may be a byzantine set of rules that are enacted.

Water's Edge Taxation. The Trump plan provides that businesses outside of the United States will no longer be taxed, and may be brought back into the US tax free. There was considerable argument earlier this year about whether this will be offset by an anti-import law, disallowing the "cost basis" in computing taxable income. Expect that the anti-import law will be imposed by the big-3 auto makers who will have more influence than Walmart and Apple in killing the anti-import proposal.

House Republications are willing to accept bringing in profits, provided that foreign earnings are taxed. The latest variation causes for immediate taxation of foreign earnings, with the tax to be paid over a period of time – the rate would be split between cash overseas and assets overseas. Still open for discussion is repatriation at a one-time tax rate. The rate discussed has

been 10 percent or 8 percent. The Framework does not address this but does identify that a 100% foreign dividends received deduction will be allowed to US Corporations owning 10%.

Import Duty @ Corporate Rates. Currently the US does not tax most goods imported or exported, and the average rate is 3% (but may very up to 20%). Replacing lost income revenue, while no tax is imposed on goods exported, all imported goods, will be subject to higher import duties, up to the corporate tax rate (15/20%) at the import value.

Tax Credits. In addition, the Plan eliminates **most** corporate tax expenditures credits except for the Research and Development credit. This means that the domestic production deduction under Section 199, which was very complicated and under-claimed will be eliminated.

Firms engaged in manufacturing in the US may elect to expense capital investments (100% deduction) and lose the deductibility of corporate interest expense. An election once made can only be revoked within the first 3 years of election; if revoked, returns for prior years would need to be amended to show revised status. After 3 years, election is irrevocable. This election will be valuable for companies like Microsoft and Apple that are debt free and do not require a corporate interest expense deduction.

The annual cap for the business tax credit for on-site childcare authorized by Sec. 205 of the Economic Growth and Tax Relief Reconciliation Act of 2001 would be increased to $500,000 per year (up from $150,000) and recapture period would be reduced to 5 years (down from 10 years).

Businesses that pay a portion of an employee's childcare expenses can exclude those contributions from income. Employees who are recipients of direct employer subsidies would not be able to exclude those costs from the individual income tax and the costs of direct subsidies to employees could not be used as a cost eligible for the credit.

The foregoing changes would have significant tax consequences. While US businesses would enjoy lower taxes, it is unclear that this would result in any repatriation of offshore earnings into the United States. While taxes are certainly a motivation for not repatriating funds, corporations doing business overseas may have non-tax reasons for retaining money offshore, including the costs of currency conversion back into US dollars.

In addition, corporations with funds offshore will tend to continue to hold moneys outside of the US for purposes of foreign investment. Also, there will likely be simply an increasing percentage of non-compliant businesses that will not report overseas activities.

From the US standpoint, one issue would be the significant reduction to funds available for federal programs. Republicans tend to disagree when it comes to drastic reductions to federal programs, particularly those that affect their constituency, including roads, farm subsidies and public projects. The GOP and Trump administration are seeking major cuts to welfare and other programs, including the SNAP cards. While the United States could substantially increase deficit spending initially to maintain programs, from past experience during the Reagan years, drastic tax cuts were immediately counterbalanced by increasing tax rates and decreases in tax

benefits in the following years. Alternatively, increasing deficits may increase interest rates and while providing short-term benefits, may actually create greater burdens on economic growth in the future.

Expectations for Enactment.

Not every proposal by an elected candidate becomes law. The realities of the budgetary process, particularly given the substantial deficit that would result from this proposal, would indicate some call for compromise. However, given a Republican House and Senate, and that the tenants proposed reflect the general sentiments of the Republican Party, many of proposed provisions, or some lesser variation thereof, may be enacted into law, but possibly in a watered down version.

While a wait-and-see approach may be prudent, these changes may mean that it is prudent to hold off on the purchase of a second – vacation home. And, once enacted, the changes may require redrafting of estate plans. For nearly 30-years the consistency in estate tax laws allowed many estate plans to not need changing. Since 2012, many estate plans are not necessarily "tax prudent" insofar as they provide for trusts that miss out on the opportunity for a step-up in tax basis by using a bypass trust rather than a marital trust for the first deceased spouse's interest. With the new legislation, additional terms may be required to eliminate a lengthy term of any irrevocable trust beyond 21-years that holds appreciated property and is established for children-if the Canadian model is followed.

Wagner Kirkman Blaine Klomparens and Youmans LLP is actively advising as to year-end tax planning in light of these proposals.

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Cameron L. Hess, CPA, Esq., represents clients principally in Northern California with respect to real estate, business, estates and trusts and tax law issues, focusing on closely held business representation. A partner with Wagner, Kirkman, Blaine, Klomparens & Youmans LLP, Mr. Hess connects to individuals, families and businesses covering diverse areas including acquisitions, advanced estate planning, tax controversy work and not-for-profits. Prior to 1991, Mr. Hess' practiced as a CPA and tax manager with KPMG Peat Marwick, an international accounting firm, in the fields of real estate, business and international tax law. For several years, managed the start-up of the Los Angeles Office's State and Local Tax Practice, where he consulted on state tax planning.

Mr. Hess is an educator, writer and activist. He serves on several nonprofit organizations. Mr. Hess was past president of the Rental Housing Association of Sacramento Valley (and continues to contribute to the organization, sitting on the local political action committee). Mr. Hess has also chaired the Real Estate Committee for the Sacramento Chapter of the CalCPA since 1992. Mr. Hess currently holds various positions with the CalCPA (Chair, RED Group; member TAX-I Conference) and State Bar of California Tax Section (Chair, Tax Section Corporate and Other Pass-Through Entities Committee.) At this moment he is assisting in developing the D.C Delegation topic to be presented to the Treasury Department, proposing tax clarifications to an existing regulation. Mr. Hess previously served on the Board of Easter Seals Superior California and as legal counsel to Easter Seals Leadership Association. Mr. Hess has instructed courses at UC Davis Financial Planning Program and at Cosumnes River College.

Mr. Hess has published/authored over two hundred articles and is a past contributor/columnist for Spidell's California Taxletter. Past national articles for professionals may also be found in CCH Taxes and The Tax Executive. His past webinars may be heard at the Strafford Group and Spidell Publishing.

Mr. Hess attended the University of California, Berkeley (*B.S. (Accounting),* 1980) where he founded the Social Action Newsletter and attended the University of Southern California (*Juris Doctor and Master in Business Taxation.,* 1983) where he was a student staff editor of Computer and Tax Law Journal.