September 28, 2017

TAX UPDATE

TAX REFORM FRAMEWORK RELEASED

WHAT'S IN IT AND WHAT QUESTIONS ARE LEFT UNANSWERED?

On September 27, 2017, the framework for the current administration's tax reform plan was released. This framework has a long way to go before becoming law. Many in government have expressed the desire to have tax reform passed prior to the end of this year. If that is to be accomplished, the many questions that the framework fails to answer and the vitally important details that have been omitted from the framework will all need addressed. Here are the major provisions included in the framework as well as some of the significant questions left to be answered:

Individual Tax Rate Structure

- The framework seeks to change the current individual tax rate structure from seven brackets ranging from 10% to 39.6% to a system with only three brackets of 12%, 25%, and 35%.
- The increase in the lowest rate is expected to be offset by the changes to be made to the standard deduction (see "Standard Deduction/Exemption Changes" item below) and other tax relief provisions so that those in the lowest current income bracket are not left worse off.
- The framework allows that an additional top rate "may apply" to the highest income taxpayers to ensure that the overall tax burden is not shifted from high-income to lower- and middle-income taxpayers.

Unanswered Questions:

1. *Most importantly, at what income levels will the new three tax brackets apply to?*
2. *What is the "cost" of reducing the highest tax bracket from 39.6% to 35%, and what offsets will be needed to help reduce this "cost"?*
3. *What is the "additional top rate" that "may apply" and at what income level? How exactly is it going to be determined if this rate is needed?*
4. *Will there be any changes to the 3.8% surtax on investment income or the 0.9% Medicare surtax on wages/self-employment income?*
5. *Will there be any change to the reduced rates allowed for qualified dividends and long-term capital gains?*

Standard Deduction/Exemption Changes

- Under the framework, the standard deduction is doubled from its current amount.
- The personal exemption is eliminated in order to simplify the tax rules. This elimination is intended to be offset by the doubling of the standard deduction as well as other tax relief provisions.
- The combination of these two changes is intended to reduce the taxes being paid by lower-income and middle-class taxpayers.

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Unanswered Questions:

1. *What will the impact be on taxpayers who do not use the standard deduction, but rather itemize their deductions?*
2. *What will the impact be on taxpayers with large families who currently use the standard deduction? Given the elimination of the personal exemptions, at what point are these taxpayers worse off?*

Itemized Deduction Changes

- The framework eliminates most itemized deductions.
- The deductions for home mortgage interest and charitable contributions are to be retained.

Unanswered Questions:

1. *Will there still be a phase-out of itemized deductions for higher-income taxpayers?*
2. *Will the definition of allowable mortgage interest remain the same?*
3. *Since the framework states "most" itemized deductions will be eliminated, are the two stated deductions to be kept (mortgage interest and charitable contributions) the only ones to remain, or will others also be retained?*

Individual AMT Tax

- The framework states that the existing individual AMT tax is to be repealed.

Unanswered Question:

1. *What will happen to individuals who have previously been subject to the AMT tax and currently have an AMT credit carried forward?*

Child Tax Credit and Middle-Class Tax Relief

- The child tax credit will be "significantly" increased.
- The income levels at which the child tax credit begins to phase out will be "increased."
- A new $500 nonrefundable credit for non-child dependent care costs will be provided for.
- The framework allows for "additional measures to meaningfully reduce the tax burden on the middle-class."

Unanswered Questions:

1. *What will the child tax credit be increased to and what are the new income levels?*
2. *What expenses will qualify for the new non-child dependent care costs?*
3. *What will the "additional measures" referred to as ways to reduce the tax burden on the middle class be?*
4. *Will the increased child tax credit be sufficient to make up for the loss of the personal exemption deduction for children?*

Estate and Generation Skipping Taxes

- The estate tax ("death tax") and generation-skipping transfer tax would be repealed.

Unanswered Question:

1. *What would be the effective date of this repeal?*

Other Individual Provisions

- The framework encourages the simplification of work, education, and retirement security and aims to maintain or raise retirement plan participation of workers.
- The framework envisions the repeal of many tax provisions to make the system simpler and fairer and to allow for lower tax rates.
- The framework provides no further details or specific proposals to support these goals.

Unanswered Question:

1. *What specific provisions would be enacted to help achieve these very general goals?*

Corporate Tax Rates

- The maximum corporate tax rate would be reduced from 35% to 20%.
- The AMT for corporations would be eliminated.
- The framework also allows for the consideration of methods to reduce the double taxation of corporate earnings.

Unanswered Questions:

1. *Assuming continued use of a progressive rate structure, what will the specific tax brackets look like?*
2. *What will happen to AMT tax credits that corporations previously subject to the AMT tax have carried forward?*
3. *What methods will be used to reduce the double taxation of corporate earnings? Does this include a possible lower tax rate on dividends?*

Small Business Tax Rate

- The tax rate applied to businesses conducted as sole proprietorships, partnerships, and S corporations would be limited to 25% (compared to the maximum individual tax rate of 35%).
- The framework contemplates that measures will be adopted to prevent the recharacterization of personal income into business income to prevent wealthy individuals from avoiding the top personal rate.

Unanswered Questions:

1. *What provisions will exist to combat the abuse of this rule—individuals using sole proprietorships, partnerships, and S corporations as vehicles to convert personal income into business income for the lower rate?*
2. *Will all businesses be eligible for this reduced rate?*
3. *How might this impact the way the Internal Revenue Service looks at "reasonable wages" paid out of S corporations?*

Capital Investment Expensing/Interest Expense Limitation

- For purchases made after September 27, 2017, businesses will be allowed to immediately write off the cost of any new asset purchase other than "structures" for at least five years.
- This will in effect replace the depreciation deduction allowed currently over the tax life of an asset.
- As an offset to this benefit, the deduction for net interest expense incurred by C corporations will be partially limited.

Unanswered Questions:

1. *How will "structures" be defined?*
2. *Will purchases that are financed be eligible?*
3. *Will there be any limits, such as the ones relating to total asset investment limits that exist for the current Section 179 expense benefit?*
4. *Will this expense be allowed to create/increase overall tax losses available for carryback?*
5. *What happens relating to the September 27, 2017 date if tax reform doesn't become law until after 2017?*
6. *How will "net interest expense" be defined?*
7. *How will the "partial" limitation of net interest expense be calculated?*

Other Corporate Provisions

- The current Section 199 credit related to domestic production will be eliminated.
- "Numerous other" exclusions and deductions will be repealed or restricted.
- Two current credits – the R&D credit and the low-income housing credit – will not be repealed or restricted in any way.
- "Special tax regimes" that exist to govern the tax treatment of certain industries and sectors will be "modernized" to better reflect economic reality and reduce opportunity for tax avoidance.

Unanswered Question:

1. *What are the important specifics regarding the numerous exclusions/deductions to be possibly repealed/restricted and the modernization of special tax regimes?*

Taxation of Global American Companies

- Foreign earnings that have accumulated oversees under the old tax system will be treated as repatriated at an undisclosed tax rate.
- Payment of this tax liability will be spread out over several years.
- Accumulated foreign earnings held in illiquid assets will be subject to a lower tax rate than foreign earnings held in cash or cash equivalents.
- There will be a 100% exemption for dividends from foreign subsidiaries in which the U.S. parent owns at least a 10% stake.

Unanswered Questions:

1. *What is the tax rate on repatriated earnings?*
2. *How many years will the tax liability be spread out?*

QUESTIONS?

If you have any questions or wish to discuss the issue further, please contact Charles Marston at (724) 934-0344 or email at cmarston@srsnodgrass.com.