Framework for Tax Reform Released

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On September 27, 2017, the Trump Administration, the House Committee on Ways and Means, and the Senate Committee on Finance released a unified framework (the Framework) with the stated goal of achieving pro-American, fiscally-responsible tax reform. The Framework promises to deliver a 21st century tax code that is built for growth, supports middle-class families, defends our workers, protects our jobs, and puts America first. In addition, the Framework pledges to broaden the tax base, close loopholes, and grow the economy.

Individual Tax Reform

Double Standard Deduction and Zero Tax Bracket

The Framework combines the personal exemption for married taxpayers and doubles the standard deduction to $24,000 for married taxpayers filing jointly and $12,000 for single filers, with the goal of creating a simpler, fairer system. The change creates a "zero tax bracket" by eliminating taxes on the first $24,000 of income earned by a married couple and on the first $12,000 of income earned by a single individual.

Individual Tax Rate Structure

Under current law, taxable income is subject to seven tax brackets (from 10% to 39.6%). The Framework consolidates the current seven tax brackets into three brackets of 12%, 25%, and 35%. The Framework alludes to an additional top rate that may apply to the highest-income taxpayers but does not provide additional detail on the rate, other than to provide that the purpose of such a rate is to ensure that the tax cuts do not shift the tax burden from high-income to lower- and middle-income taxpayers. The Framework also envisions the use of a more accurate measure of inflation for purposes of indexing the tax brackets and other tax parameters.

The Framework is silent on any changes to the preferential rate structure for long term capital gains and qualified dividend income, currently taxed at a maximum rate of 20% for Federal income tax purposes. The Framework is also silent on the exemption of municipal bond interest from Federal income tax.

Child Tax Credit and Middle Class Tax Relief

The Framework repeals personal exemptions for dependents and significantly increases the Child Tax Credit. The first $1,000 of the credit will be refundable as under current law. In addition, the Framework will increase the income levels at which the Child Tax Credit begins to phase out, thereby making the credit available to higher income families and eliminating the marriage penalty in the existing credit. The Framework also provides a non-refundable credit of $500 for non-child dependents to help defray the cost of caring for other dependents, such as parents or other family members.

Alternative Minimum Tax Repeal

The Framework proposes a repeal of the existing individual AMT. The Framework notes that the nonpartisan Joint Committee on Taxation (JCT) and the Internal Revenue Service (IRS) Taxpayer Advocate have both recommended repealing the AMT because it no longer serves its intended purpose and creates significant complexity.

Itemized Deductions

The Framework eliminates most itemized deductions but retains tax incentives for home mortgage interest and charitable contributions. It is not clear whether the current deductions for home mortgage interest or charitable contributions would remain in their current form or if they would be retained but materially limited.

Significantly, the Framework would eliminate the deduction for state and local taxes, such as state income taxes, real estate taxes, and personal property taxes. Because state and local taxes are often the largest itemized deductions for many high income taxpayers, this may have the indirect effect of reducing the benefit of other deductions, such as the charitable and home mortgage interest deduction, because the standard deduction may be larger than the aggregate of the available deductions. A number of powerful industry groups have come out in opposition to the elimination of the state and local tax deduction. While this provision tends to hurt residents of states, such as New York, New Jersey, California, Illinois, and Texas, that have high state and local income or property taxes, these states have Republican members in the House who may have difficulty supporting such a provision. As a consequence, it is not clear whether this provision will survive the legislative process.

Retirement Plan Provisions

The Framework does not provide any specifics on changes to retirement plan incentives but states the goal of retaining tax benefits that encourage work, higher education and retirement security. The Framework's ultimate stated goal is to improve efficiency and effectiveness and maintain (or raise) retirement plan participation of workers and the resources available for retirement.

Estate Tax Provisions

The Framework calls for the repeal of the estate tax and the generation skipping transfer (GST) tax. There is no mention of the repeal of the gift tax. It is commonly thought that the gift tax acts as a backstop on the income tax. For example, it discourages income shifting that might occur when property is gifted from a high-income tax bracket taxpayer to a lower income tax bracket taxpayer, who sells the property and then gifts the proceeds back to the high-income tax bracket taxpayer.

The Framework is silent on whether the basis adjustment at death equal to the fair market value would be retained or if a carryover basis regime would apply. In 2010, when the estate tax was repealed for one year, taxpayers who died that year were given a limited $1.3 million basis adjustment for most transfers and a $3 million basis adjustment for transfers to a surviving spouse. Under current law, taxpayers have a $5.49 million estate, gift, and GST tax exemption (for a total of $11.98 million for a married couple) with a full basis adjustment at death.

Business Tax Provisions

Tax Rates for Small Businesses

The Framework provides for a 25% maximum tax rate applied to the business income of small businesses conducted as sole proprietorships, partnerships, LLCs, and S corporations. Because of the incentive to recharacterize wage-related income as business income, the Framework contemplates anti-abuse measures to prevent wealthy individuals from avoiding the top personal tax rate. This anti-abuse provision may be aimed, among other things, at taxing carried interest income received by principals in private equity firms. In addition, professional services firms will look to restructure their compensation models to take advantage of the lower tax rates.

Reduction of Corporate Tax Rate

The Framework reduces the corporate tax rate to 20% – which is below the 22.5% average of the industrialized world. In addition, it aims to eliminate the corporate AMT, as recommended by the non-partisan JCT. The committees also may consider methods to reduce the double taxation of corporate earnings.

Current Expensing of Capital Investments

The Framework allows businesses to immediately write off (or "expense") the cost of new investments in depreciable assets other than structures made after September 27, 2017, for at least five years, which is unprecedented. Interestingly, tax legislation is typically effective when enacted, but the proposed September 27, 2017 effective date for full expensing is intended to provide comfort to and encourage businesses to make capital investments before final legislation is enacted.

Interest Expense Deduction

The Framework provides that the deduction for net interest expense incurred by C corporations will be partially limited and provides that the tax-writing committees will consider the appropriate treatment of interest paid by non-corporate taxpayers. This could be disadvantageous to many sectors, including the real estate industry.

Business Deductions and Credits

The Framework provides that the current law domestic production deduction under Code Section 199 will no longer be necessary since the rate reductions and current expensing of capital investments provide substantial tax benefits. Without providing any specific detail, the Framework alludes to numerous other special exclusions and deductions that will be repealed or restricted. The Framework explicitly preserves the research and development (R&D) and low-income housing tax credits, which have proven to be effective in promoting policy goals important to the American economy.

International Tax Provisions

Territorial Taxation Of Global American Companies

The Framework works to end the incentive to keep foreign profits offshore by exempting them when they are repatriated to the United States. It will provide a 100% exemption for dividends from foreign subsidiaries (in which the U.S. parent owns at least a 10% stake). To transition to this new system, the Framework treats foreign earnings that have accumulated overseas under the old system as repatriated. Accumulated foreign earnings held in illiquid assets will be subject to a lower tax rate than foreign earnings held in cash or cash equivalents although the Framework does not provide specific rates. Payment of the tax liability will be spread out over several years.

Measures to Stop Expatriation

To prevent companies from shifting profits to tax havens, the Framework states that additional rules will be provided to protect the U.S. tax base by taxing the foreign profits of U.S. multinational corporations at a reduced rate and on a global basis. The committees will incorporate rules to level the playing field between U.S.-headquartered parent companies and foreign-headquartered parent companies.

Conclusion

It is expected that the tax-writing committees of Congress will use the Framework as the basis for formulating the specifics of tax legislation. We will continue to provide updates on this important legislation as additional details emerge.

Related People

- Farhad Aghdami – 804.420.6440 – aghdami@williamsmullen.com
- Anna K. Derewenda – 804.420.6094 – aderewenda@williamsmullen.com
- J. Conrad Garcia – 804.420.6910 – cgarcia@williamsmullen.com

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