Tracking Tax Reform

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April 5, 2017

With the recent release and subsequent quick defeat of the American Health Care Act (AHCA), healthcare reform dominated the news and tax reform was waiting for its turn in the spotlight. Tax reform was a major issue on the campaign trail as well as immediately following President Trump's election on November 8 and subsequent inauguration. Even throughout the debates over the House Republican replacement for the Affordable Care Act, Republican members of Congress still expressed confidence that tax reform would be delivered this summer. With the failure of the AHCA, tax reform now seems to be the highest priority item on the White House agenda (unless, as has been recently speculated, healthcare reform has not been completely abandoned).

As the prospects for tax reform now have improved, we have created a brief compilation of the key aspects of tax reform that have been discussed by President Trump[1] and the House Republicans[2] to date. This guide is intended to simplify the process by focusing on the most important aspects of tax reform and help you keep track of the various components involved. Amidst all of the technical details of the various proposals, it is helpful to bear in mind that the type of comprehensive reform being considered always means that any tax cuts will be financed by a loss of specific tax benefits (i.e., tax deductions and credits). Indeed, for some taxpayers, "be careful what you wish for."

What to Watch For:

Individual Taxation.

- **Streamlining returns.** Both President Trump and the House Republicans have expressed the desire to streamline the tax return process for the majority of individuals by making individual tax returns shorter and easier to complete. The House Republicans' proposal envisions a 14-line tax return that can easily fit on a postcard. Exactly how simplified the process can become will depend on how many of the other changes discussed below are passed.
- **Rates**. Both President Trump and the House Republicans have discussed condensing the current eight brackets (ranging from 10% to 39.6%) into three brackets – 12%, 25%, and 33%. Under both proposals, the highest income bracket drops by more than 6 percentage points, or about 17%. The proposals do vary when it comes to the income amounts that are taxed in each bracket. Both have expressed the desire to eliminate the 3.8% surtax on net investment income exceeding $200,000 ($250,000 for those married filing jointly), and the 0.9% Medicare surtax on wages over $200,000 ($250,000 for those married filing jointly), but it is unclear if these taxes would be repealed if the Affordable Care Act is not also repealed.
- **Increase in standard deduction, elimination of almost all itemized deductions.** The House Republicans have proposed almost a complete elimination of the itemized deduction system in exchange for a higher standard deduction. Under their proposal, an individual can subtract from their income either (i) the standard deduction or (ii) the mortgage interest and charitable contribution deductions. The only credits that would remain are the child credit, earned income credit, and higher education credit. President Trump has suggested a cap on itemized deductions and has informally indicated he likes the House Republicans' proposal to eliminate almost all deductions.
- **Elimination of the Alternative Minimum Tax.** Both President Trump and the House Republicans have called for the complete elimination of the Alternative Minimum Tax (for both individuals and corporations).

Endnotes

[1]Source: President Donald Trump's campaign materials and subsequent remarks regarding tax reform that have been made by him or members of his administration.

[2]Source: The House Republican Blueprint "A Better Way" (published June 24, 2016).

- **Taxation of investment income.** President Trump has proposed maintaining the current taxation system for dividends and capital gains, leaving the top rate at 20%. The House Republicans have proposed taxing an individual's investment income (defined to include interest – which is currently taxed at ordinary rates, capital gains, and dividends) at 50% of that individual's ordinary income tax rate – bringing the top rate down to 16.5%.

Business Entity Taxation.

- **Rates**. Both President Trump and the House Republicans want corporate rates to drop from the current top rate of 35% (one of the highest in the world). The question remains how low they will go – President Trump has called for 15%, while the House Republicans are proposing 20%. As mentioned above, both Preisdent Trump and the House Republicans have called for the elimination of the corporate Alternative Minimum Tax.
- **Taxation of pass-through income to entity owners.** The House Republicans want to tax active business income derived from pass-through entities (i.e., S corporations, LLCs, partnerships) to their owners at a maximum rate of 25%, rather than the ordinary individual income tax rates that such income is currently taxed at. Characterization of income as active appears to be determined at the entity level, but this is currently unclear. Their proposal applies these rates to active business income after the deemed payment of reasonable compensation to owners and partners that also provide services to the entity, as a means of preventing tax avoidance. It is not clear how reasonable compensation would be calculated. President Trump's position is less clear – he had previously proposed a special rate of 15% that would apply to income earned through a pass-through entity, but has more recently seemed to waver on this position.
- **Changes to depreciation and interest deductions.** The House Republicans have proposed that businesses be allowed to immediately and fully expense 100% of all business investments (other than land), which is a stark contrast to the current complex depreciation and amortization systems that space deductions out over varying periods of years. This plan appears to be a bold move towards a cash-flow based taxation system, and would be a radical change if adopted. President Trump has more modestly suggested a system of optional expensing of investments for certain manufacturers. The House Republicans also want to limit the deduction of interest expenses to the amount of interest income, but allow corporations to carry forward unused interest expenses indefinitely. Regarding interest deductions, President Trump merely states that manufacturers that elect to immediately expense capital investments would lose the corporate interest expense.
- **Business incentives.** As a trade-off for the lower corporate tax rates, both President Trump and the House Republicans are calling for the general elimination of business incentives and credits, other than the R&D credit, which would remain intact. This means that all business incentives for specific industries, such as real estate and oil and gas, could be eliminated. The House Republicans have proposed that net operating losses be allowed to be carried forward indefinitely (with no carrybacks) and be increased by an adjustment factor to account for inflation. The amount of the deduction allowed with respect to a carryforward would be limited to 90% of the taxpayer's net taxable income for any year.
- **Carried Interest.** The current taxation of carried interests at capital gains rates (top rate of 20%) has been controversial for several years. The House Republicans do not put forth a specific proposal on this, but if their proposal regarding taxation of investment income were to pass, income from carried interests could be taxed at a top rate of 16.5%. President Trump states that he will tax carried interest income as ordinary income, but if proposals regarding taxation of income earned through pass-through entities were to pass, this rate could be 15%. These tax rates could be higher if this income is treated as "reasonable compensation" under the House Republican version of taxation of pass-through entities (described above).

International Taxation.

- **Tax on future foreign earnings.** With exceptions for certain kinds of passive and tax haven income, the United States currently imposes a tax on trade or business income on a worldwide basis (paid when income is repatriated, with the burden being reduced by the foreign tax credit system, and with many companies deferring this tax by leaving income offshore). President Trump at one point on the campaign trail appeared to support the immediate worldwide taxation of all corporate income and the repeal of deferral, but it is not clear where he currently stands on this issue. The House Republicans have proposed moving to a territorial system and eliminating the foreign tax credit system. A territorial system would not impose a tax on corporate income earned outside of the United States, even when repatriated, and would thus eliminate the need for the foreign tax credit system.
- **Tax on accumulated foreign earnings.** President Trump has proposed a one-time mandatory repatriation tax at a rate of 10% on accumulated offshore earnings. The House Republicans have proposed that accumulated foreign earnings be subject to a mandatory 8.75% tax (for cash and cash equivalents) and a 3.5% tax (for other holdings), with the tax payable over eight years.
- **Border Adjustment Tax.** This aspect of potential corporate tax reform has thus far proven to be the most controversial, and recently Congress has been discussing backing off of this proposal (though perhaps in exchange for less significant corporate tax rate cuts). The House Republicans have proposed to tax companies' domestic sales and imports, while exempting their exports. President Trump has seemingly wavered on this idea, at times appearing to support it, while at other times dismissing the plan for being too confusing. There are also concerns that a Border Adjustment Tax might be challenged by the World Trade Organization.

Future Updates

The proposals described above are just as comprehensive as the last major tax reform legislation enacted by Congress, the 1986 tax reform bill, which became the "Internal Revenue Code of 1986." Accordingly, these proposals will travel a long and winding road before they become law. We will provide updates when appropriate to help you keep track of the tax reform proposals.

For more information on the matters discussed in this *Locke Lord Article*, please contact the authors.

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