Highlights

- Reduced individual tax rates
- Elimination of many itemized deductions
- 20 percent corporate tax rate
- Repeal of federal estate tax
- Repatriation tax break

Inside

By Linda O'Brien, J.D., LL.M.

Tax Reform Proposal Signals White House Broad Tax Policy for 2017

EXECUTIVE SUMMARY

Republican lawmakers began 2017 with a goal of overhauling the tax code. President Trump on April 26 proposed a one-page tax reform outline—"2017 Tax Reform for Economic Growth and American Jobs"—that called for dramatic tax cuts and simplification: providing lower individual tax rates under a three-bracket structure; doubling the standard deduction; reducing the corporate tax rate; and changing the tax treatment of pass-through entities. The federal estate tax, alternative minimum tax, and net investment income tax would be eliminated.

On September 27, the Trump Administration, the House Committee on Ways and Means, and the Senate Finance Committee unveiled their nine-page proposal, the "Unified Framework for Fixing Our Broken Tax Code." The framework is intended to serve as a template for Congress to develop legislation through the committee process. The framework, which builds on the broader outline released by the Trump Administration in April, is just a proposal. No legislative text has been revealed.

Congressional Republicans plan to use the budget reconciliation process to fast-track a tax bill in the Senate with a simple GOP majority. The House approved the Fiscal Year (FY) 2018 Budget Resolution by a 219-206 vote on October 5, which calls for $203 billion in cuts to mandatory spending over 10 years. Meanwhile, the Senate Budget Committee approved its own budget resolution on October 19 that would allow for $1.5 trillion in tax cuts. The Senate budget resolution included a last-minute amendment negotiated with House leaders that could bypass the need for a conference committee. The House is scheduled to vote on October 26 on the Senate budget resolution. Once a budget is passed, the House Ways and Means Committee will announce the date of a bill release and bill markup.

WHITE HOUSE/GOP FRAMEWORK

INDIVIDUALS

Tax Rates

The framework calls for replacing and lowering the current seven individual tax rates with a new three-bracket structure: 12, 25, and 35 percent. Under current law, individual income tax rates are 10, 15, 25, 28, 33, 35, and 39.6 percent.

IMPACT. *The proposed income ranges for the new brackets was not included in the framework. It is difficult to determine whether taxpayers would see an increase or a decrease in their effective rate even when considering the effect of a proposed higher standard deduction.*

"The elimination of many itemized deductions would channel an even greater number of taxpayers to use the standard deduction."

COMMENT. *House Speaker Paul Ryan indicated that the House plans to introduce a fourth tax bracket so that high-income earners would not receive a windfall under the tax plan. No further details were provided.*

Standard Deduction

The plan also calls for roughly doubling the standard deduction for individuals—$24,000 for married filing jointly and $12,000 for single filers. The change would increase the standard deduction amounts from the 2017 levels of $12,700 and $6,350, respectively, as adjusted for inflation.

IMPACT. *The increased standard deduction amounts would be an incentive for taxpayers not to itemize their deductions on their returns and instead use the standard deduction. Additionally, a higher standard deduction effectively creates a more broadly applicable "zero tax bracket" for taxpayers earning less than the standard deduction amount.*

Deductions

All individual tax deductions would be eliminated under the GOP plan except for the mortgage interest deduction and charitable contribution deduction. Other exemptions, deductions, and credits also would be eliminated, including the deduction for personal and dependency exemptions.

IMPACT. *The loss of the medical expense deduction and miscellaneous itemized deduction will prove difficult for some taxpayers. Other losers may include taxpayers in high-tax states, such as New York, New Jersey, Illinois, and California that use the popular deduction for state and local taxes as well as state and local governments that depend on the deductions for state and local income taxes and real estate taxes as indirect subsidies for those taxes.*

IMPACT. *The elimination of many itemized deductions would channel an even greater number of taxpayers to use the standard deduction.*

Family Incentives

The framework indicates that the child tax credit would be significantly increased, although the

GOP Tax Reform Framework

Proposal	Unanswered Questions
Individual tax rates reduced from seven brackets into three: 12%, 25% and 35%	Income thresholds for each tax bracket
Most individual itemized tax deductions and personal exemptions eliminated	Which households would pay more and which would pay less
Child tax credit increased	Amount of the increase unspecified
Tax rate on owners of pass-through businesses reduced to 25%	Rules to prevent business owners from reclassifying wages as business income
One-time repatriation tax holiday	Rules to prevent companies from shifting profits abroad
Estate tax and alternative minimum tax repealed	How much the tax plan would add to the deficit

amount of the increase was not specified. As under current law, the first $1,000 of the child tax credit would be a refundable credit. Income limitations on the child tax credit—currently thresholds of $110,000 married filing jointly, $75,000 single filers, and $55,000 married filing separately—would be increased. The plan also provides for a $500 credit for the care of non-child dependents.

> **IMPACT.** *Under current law, taxpayers who incur expenses for a qualified child or for an incapacitated dependent or spouse in order to work or look for work may claim a credit of 20 to 35 percent of employment-related expenses, depending on income level and other factors. It is unclear if the proposed $500 credit is in addition to the existing child and dependent care credit or a replacement of that credit.*

Estate Tax

The current maximum federal estate tax rate is 40 percent, with an estate and gift tax exclusion of $5.49 million per individual in 2017. The GOP proposal would repeal the federal estate tax and generation-skipping transfer tax.

> **IMPACT.** *The proposal does not answer the question of what will become of the gift tax.*

Alternative Minimum Tax

The framework would abolish the alternative minimum tax (AMT). The AMT, a parallel tax system, was originally designed to ensure that individuals, corporations, estates, and trusts with substantial income do not avoid tax liability by eliminating large deductions. However, despite exemptions, the AMT has captured an increasing number of taxpayers.

> **IMPACT.** *Although the AMT serves as a revenue source, significant tax reform would likely present other options to offset the cost of its elimination.*

BUSINESSES

Corporate Tax

The corporate income tax rate would be reduced to 20 percent under the GOP proposal. The maximum corporate tax rate currently tops out at 35 percent. The plan also calls for the elimination of the corporate alternative minimum tax.

> **COMMENT.** *Although the current maximum corporate tax rate is 35 percent, many corporations now pay an effective tax rate that is considerably less. In his April outline, the President proposed to eliminate unspecified tax breaks for "special interests," which would broaden the tax base and prevent most businesses from gaining an effective tax rate much lower than 15 percent.*

Business Tax Benefits

There are a number of business incentives that are proposed in the framework. Specifically, the plan effectively allows for 100 percent bonus depreciation for investments for a five-year period beginning in 2017. Currently, first year "expensing" of capital investments is limited to 50 percent of the cost, decreasing to 30 percent for investments made in 2019.

> **IMPACT.** *It is unclear under the framework what is the impact of Section 179 expensing, which is available to small businesses on qualifying used as well as new assets.*

The framework calls for the elimination of the domestic production activities deduction, indicating that manufacturers will no longer need the benefit of this deduction due to the substantial reduction in the corporation tax rate. The proposal also calls for a partial limitation of the deduction for net interest expenses for corporations, as well as consideration of the appropriate treatment of interest paid by non-corporate taxpayers.

The low-income housing credit and research and development credit remain untouched. The proposal indicates that certain special tax regimes that apply to certain industries should be modernized to reflect economic reality and prevent the use of these regimes to avoid tax.

Pass-through Businesses

Currently, income to owners of sole proprietorships, partnerships, limited liability companies, and S corporations are taxed under regular individual income tax rates (the top individual rate is 39.6 percent). Under the proposal, the owners of pass-through entities could elect to be taxed at a flat rate of 25 percent on their pass-through income retained within the business.

> **IMPACT.** *Small business owners would see their top tax rate reduced from 39.6 to 25 percent under the proposal.*

> *"Although the current maximum corporate tax rate is 35 percent, many corporations now pay an effective tax rate that is considerably less."*

INTERNATIONAL

Repatriation

The plan calls for a one-time tax on repatriated profits at an unspecified tax rate as an incentive to companies to bring several trillion dollars currently being held in other countries back to the United States for investment and hiring.

> **IMPACT.** *The lower corporate tax rate of 20 percent may also provide an incentive for businesses to not shift operations overseas going forward.*

Territorial Tax Regime

The proposal's repatriation plan is a transitional step that would move the United States from a worldwide tax regime to a territorial tax regime. Under a territorial tax system, domestic parent corporations would be entitled to a 100 percent "exemption" of dividends received from 10 percent-owned foreign subsidiaries.

> **COMMENT.** *A territorial tax system would mean that U.S. companies would pay tax on income related to the United States and not be subject to worldwide income.*

ACA TAXES

In September, Republican lawmakers abandoned their effort to repeal and replace the Affordable Care Act (ACA). The House had passed the "American Health Care Act" in May, while the Senate released its version, "Better Care Reconciliation Act of 2017." The Senate GOP pulled the bill from consideration, however, because of the unlikelihood of passage. As a result, the ACA individual and employer mandates, health insurance premium tax credit, excise taxes, as well as the 3.8 percent net investment income (NII) tax on higher-income individuals remain in place.

DISASTER RELIEF

Permanent disaster relief tax provisions could be included in a tax reform bill. For natural disasters in recent years, the majority of legislation introduced has been temporary in nature, such as bills helping victims of Hurricanes Katrina, Rita, and Wilma in 2005.

Currently, the House approved the Disaster Tax Relief and Airport and Airway Extension Bill of 2017 (H.R. 3823) on September 28 by a 264-to-155 vote. The measure was then sent to the Senate, where it was approved by unanimous consent the same day, but with an amendment removing a flood insurance provision. The President signed the legislation on September 29.

The bill eliminates the current law requirements in the disaster areas that uncompensated personal casualty losses exceed 10 percent of adjusted gross income to qualify for a deduction; eliminates the current law requirement that taxpayers itemize deductions to access this tax relief; provides an exception to the 10-percent early retirement plan withdrawal penalty for qualified hurricane relief distributions; allows for the re-contribution of retirement plan withdrawals for home purchases cancelled due to eligible disasters; provides flexibility for loans from retirement plans for qualified hurricane relief; temporarily suspends limitations on charitable contribution deductions associated with qualified hurricane relief made before December 31, 2017; provides a tax credit for 40 percent of wages (up to $6,000 per employee) paid by a disaster-affected employer to each employee from a core disaster area; and allows taxpayers to refer to earned income from the immediately preceding year for purposes of determining the Earned Income Tax Credit and Child Tax Credit for the 2017 tax year.

CONCLUSION

The chance that Congress will pass comprehensive tax reform in 2017 remains in question. President Trump and GOP lawmakers hope to get a tax plan through Congress by the end of the year and are moving through the initial steps to make that possible, including passing a budget. However, House and Senate Democrats remain largely united in their opposition of Republican efforts toward tax reform as outlined by the White House/GOP framework. The plan's proposed repeal of state and local tax deductions is opposed by House Republicans who represent districts in high-tax states, such as New York. In addition, some Republican lawmakers will need to be convinced that the proposed tax cuts will pay for themselves through economic growth after a Budget Committee report using conventional scoring methods showed that the proposal would add to the deficit. Although the House and Senate tax staff members continue to work on the details of the tax legislation, the days remaining on the legislative calendar are dwindling for Congress to tackle the issues of taxes and funding the government.