TAX ALERT

TAX REFORM FRAMEWORK RELEASED

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The Trump Administration recently released its tax reform proposal, named the "Unified Framework for Fixing Our Broken Tax Code." The framework was the result of many discussions and meetings over the past few months led by the so called Big Six – Treasury Secretary Steven Mnuchin, National Economic Director Gary Cohn, House Ways and Means Committee Chairman Kevin Brady (R-TX), House Speaker Paul Ryan (R-WI), Senate Majority Leader Mitch McConnell (R- KY), and Senate Finance Committee Chairman Orrin Hatch (R-UT).

The framework provides significant tax rate cuts for corporations and passthrough entities, a reduction of the number of individual income tax brackets, enhanced expensing for certain corporate deductions, elimination of certain individual itemized deductions, repeal of the individual and corporate alternative minimum tax, repeal of the estate and generation skipping transfer tax, and a move to a territorial taxation system for corporations, with a one-time repatriation tax. The framework, however, does not provide many details underlying these general concepts.

According to the document released by the Trump Administration, the framework aims to meet the following four principles:

- "Make the tax code simple, fair and easy to understand;
- Give American workers a pay raise by allowing them to keep more of their hard earned paychecks;
- Make America the jobs magnet of the world by leveling the playing field for American businesses and workers; and
- Bring back trillions of dollars that are currently kept offshore to reinvest in the American economy."

Individual Tax Provisions

Individual Tax Brackets. Individuals are currently subject to a tiered income tax structure with seven increasing tax rates based upon income level – with a maximum income tax rate of 39.6%. The framework reduces the tiered tax rate structure to three income tax rates – 12%, 25% and 35%. There is arguably a fourth tax rate, 0%, for those with taxable income below the proposed standard deduction (discussed below). It is interesting to note that the framework indicates that an additional top rate may apply to the highest income taxpayers, to ensure that the reformed tax code is at least as progressive as the existing tax code and does not shift the tax burden from high income to lower and middle income taxpayers. Neither the potential additional top rate nor the tax brackets were detailed in the framework.

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> *The inclusion of the potential for an additional top income tax rate opens the window for more negotiation between the various parties charged with turning the framework into law. Although the framework reduces the top income tax rate and the number of income tax brackets, the lack of details prevents taxpayers from fully analyzing the impact on their individual situation. Also notably absent from the framework was any mention of a change in the capital gains tax rate.*

Standard Deduction. The framework replaces the current standard deduction and personal exemption with a new standard deduction for both single and married individuals filing jointly. The new standard deduction is $24,000 for married taxpayers filing jointly and $12,000 for single filers.

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> *The higher standard deduction may eliminate the necessity of itemizing deductions for some taxpayers. Without the need to itemize their tax deductions, taxpayers may alter those spending and charitable gifting habits that were, at least partially, based upon tax benefit. This could affect both charities and the real estate market because mortgage interest and charitable contributions may not be as valuable as they are currently.*

Individual Alternative Minimum Tax. The framework eliminates the individual alternative minimum tax.

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> *If the deduction for state and local income taxes and miscellaneous itemized expenses are eliminated, the effect of the repeal of alternative minimum tax may not be very significant for a majority of those affected.*

Itemized Deductions. The framework proposes to eliminate most itemized deductions other than home mortgage interest and charitable contributions. This apparently means that the deduction for state and local income taxes is eliminated. Representatives of high income tax states such as New York and New Jersey have already voiced their opposition to this provision.

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> *The elimination of the state and local income tax deduction is controversial. As with the entire framework, no further detail is provided. Some*

questions that arise are: 1) Will the mortgage interest deduction be limited as it is under current law, 2) Will the maximum amount of mortgage debt, for which a mortgage interest deduction is allowed, be reduced, 3) Will the charitable contributions be subject to the myriad limitations and rules as they are under current law or will this area be simplified in the spirit of overall tax simplification?

Work, Education and Retirement. Tax benefits that encourage work, higher education and retirement security are retained in the framework. Improvements to the efficiency and effectiveness of these benefits are left to the tax writing committees.

Death and Generation Skipping Transfer Taxes. The estate tax, referred to as the "death" tax in the framework, and the generation skipping transfer tax are repealed. The framework does not mention gift taxes so it is expected that the gift tax will not be repealed. The framework also does not mention anything regarding the basis step up at death or a capital gains tax to be paid at death or by a beneficiary based on the unrealized gain inherent in a decedent's assets.

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Retaining the gift tax prevents taxpayers from removing assets from their estate in order to avoid a potential capital gains tax at death.

Enhanced Child Tax Credit and Middle Class Tax Relief. The framework repeals the personal exemption for dependents and increases the Child Tax Credit. It does not indicate the amount of the Child Tax Credit, but it indicates that the first $1,000 will still be refundable. It provides for an increase in the income levels at which the Child Tax Credit begins to phase out, thereby making the credit available to more middle income families, and it eliminates the marriage penalty in the existing credit. The tax writing committees are responsible for working on additional measures to meaningfully reduce the tax burden on the middle class.

Domestic Corporate Tax Provisions

Corporate Tax Rate Reduction & Elimination of Corporate AMT. The proposed tax framework calls for a reduction in the top corporate tax rate from 35% to 20%. The framework notes that the average corporate tax rate in the industrialized world is currently 22.5% and cites the comparatively high corporate rates in the US as a contributing factor to job losses and lower wages in the US. The framework proposes to mitigate these effects by reducing the corporate tax rate below the international average. Consideration will also be given to reducing the burden of double tax on undistributed C Corporation earnings. Consistent with these objectives, the framework also proposes full repeal of the Corporate Alternative Minimum Tax, or "AMT."

Flowthrough Rate Reduction. The framework proposes a 25% tax rate to apply to all income earned by small businesses organized as sole proprietorships, partnerships, LLCs, S Corporations, or similar flow-through entities. This would reduce the federal income tax burden on many small businesses, in an effort to spur job growth and the economy generally.

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The reduced rate for flowthrough income would also exacerbate existing tension with the IRS concerning compensation paid to owners of flowthrough entities, particularly S Corporations. Currently, the IRS takes the position that owners of S Corporations must be paid reasonable compensation for their services to protect the payroll tax base. A differential in the income tax rate between flowthrough income and earned compensation would give the IRS even greater incentive to challenge the amounts paid to flowthrough owners.

Current Deduction for Capital Investments. The framework would allow businesses (regardless of tax classification) to claim a current deduction for new investments (after September 27, 2017) in capital assets in lieu of the current regime of bonus, accelerated, and ordinary depreciation deductions provided for under the Code. Investments in real property are not eligible to be immediately expensed under the framework.

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The framework aims to provide an "unprecedented" tax benefit for capital investments, both in terms of the duration of the benefit and scope of assets covered. Prior tax incentives have allowed temporary "100% bonus" depreciation deductions. It is not clear whether the deduction for capital investments will be made a permanent part of the business tax provisions, but the framework suggests it will at least eclipse the duration of these prior programs.

Interest Expense. The deduction for net interest expense may be partially limited for C Corporations under the terms of the framework. The framework contemplates that a similar limitation may be put in place for other businesses. Details concerning this provision have yet to be determined.

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Eliminating or limiting the deduction for net interest expense would reduce the incentive to capitalize C Corporations with shareholder debt as opposed to equity contributions. This may help both to simplify the tax code and to protect the corporate tax base from erosion through leveraging up otherwise profitable businesses with shareholder debt. However, it remains to be seen what will happen with interest expense attributable to existing debt arrangements. Furthermore, we may see a decrease in acquisitive transactions and other types of business succession planning.

Repeal of Deductions and Credits. The framework contemplates that the reduction in rates will be partially funded through the repeal of certain business deductions and credits. Specifically, the Domestic Production Activities Deduction contained in current Code Section 199 would be eliminated under the framework. Other deductions and credits may also be repealed.

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The Section 199 deduction and various credits targeted for repeal are intended to incentivize certain industries, such as manufacturing operations. With the proposed reduction in business tax rates, these special incentives seem to be viewed as unnecessary or redundant. The framework notes, however, that the research and development and low-income housing credit should be preserved due to their positive impact on the US economy.

Along similar lines, the framework calls for the review and revision of tax regimes that apply only to certain industries in order to modernize the tax code and reduce opportunities for tax avoidance. Specifics concerning the industries affected and the criteria for reform, however, are not discussed.

International Corporate Tax Provisions

Significant changes were proposed with respect to international corporate taxation.

Territorial Tax System. The administration proposed the introduction of a territorial tax system for corporations to replace the current worldwide profit taxation principle. Further, there is a complete tax exemption for dividends received by US companies from their foreign subsidiaries, provided there is a minimum 10% participation.

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The proposed switch to the territorial tax system comes as no surprise and is in line with the initial suggestions by the Trump Administration.

While transition into a territorial tax system combined with a reduction in domestic corporate taxes to 20% is regarded by many as a welcome move, it is sure to create a great degree of, at least temporary, uncertainty. Without a doubt, the tax reform will necessitate special transition rules and provisions, especially as it concerns previously accumulated foreign earnings.

Currently, US multinationals structure their operations differently using either tax transparent entities (LLCs. Partnerships), or tax opaque entities (Limited Companies, Corporations) or even hybrid entities (transparent in one jurisdiction, while opaque in another). Furthermore, significant planning goes into determining a proper tax efficient combination of debt and equity in financing of their foreign operations. Transition into a territorial tax system and a zero dividend tax may put some existing tax structures at a disadvantage while creating new loopholes for others. Coordination may be necessary between taxation of profits received through various types of entities and instruments.

One Time Offshore Profits Repatriation Tax. A one-time repatriation tax on profits accumulated offshore is being introduced. Previously accumulated foreign profits will be deemed repatriated and taxed at different rates according to the type of assets: a higher tax rate will apply to cash and other liquid assets, and a lower tax rate will apply to all other illiquid assets. The payment of repatriation tax will be spread over an unspecified period of time. In professional circles, it is suggested that this period may be anywhere from five to eight years.

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Coordination with Anti-Tax Deferral Regimes is necessary. Today, US multinationals are taxed on their worldwide profits and are subject to various anti-tax deferral provisions. One set of such rules is referred to as a Controlled Foreign Corporations ("CFC") regime. The CFC regime imposes taxation on certain passive income and related party income of foreign subsidiaries, even in the absence of dividend distributions. CFC regime taxation thus only captures certain types of income that are notorious for being prone to tax avoidance techniques. The CFC rules do *not normally affect the course of businesses' foreign profits. It is unclear whether the repatriation tax will be applied to all, or only to certain types of, foreign accumulated earnings.*

Anti-Base Erosion and Profits Shifting Provisions.
Anti-base erosion and profit shifting provisions will be enhanced in order to put US multinationals on par with their foreign counterparts and assure the effectiveness of the new territorial tax system.

There are not many details available as to what specific anti-avoidance mechanisms would apply.

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It is likely that the methods suggested by the Organization for Economic Cooperation and Development (OECD) under the Base Erosion and Profit Shifting initiative (BEPS) framework may be implemented in the US. If this is the case, it may create additional information and reporting compliance obligations for the multinationals. If not coordinated with the existing obligations, it may defeat the goal of the administration to minimize and simplify the reporting burden.

The tax writing committees must now take this guidance and turn it into legislation. We will continue to monitor the progress of tax reform. Please contact your Mazars USA LLP professional for additional information.

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