TAX ALERT

TRUMP ADMINISTRATION RELEASES TAX REFORM PLAN

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On April 26, the Trump Administration released its plan for tax reform. National Economic Council Director Gary Cohn and Treasury Secretary Steven Mnuchin gave a high level explanation of the plan at a press briefing and indicated that the administration will hold listening sessions with stakeholders throughout the month of May to receive their input and will work with congressional leaders to address the details underlying the broad objectives of the plan.

Key goals include job creation and economic growth, providing tax relief to low and middle income families, simplifying our burdensome tax code, and lowering the business tax rate from one of the highest in the world to one of the lowest.

Individual Tax Proposals

Individual Tax Brackets: Individuals are currently subjected to a tiered income tax structure with seven increasing tax rates based upon income level - with a maximum income tax rate of 39.6% for top earners. President Trump's proposal reduces the tiered tax rate structure to three income tax rates - 10%, 25%, and 35%. The rates are similar to those proposed by President Trump during his campaign (12%, 25% and 33%). The exact brackets associated with each tax rate would be worked out during discussions with congressional leaders.

Net Investment Income Tax: The proposal would eliminate the 3.8% tax on net investment income. No mention was made of eliminating the additional .9% Medicare tax on earned income above certain thresholds.

Standard Deduction: The proposed income tax plan replaces the current standard deduction with a new standard deduction for both single and married individuals. President Trump's proposal calls for a "doubling [of] the standard deduction." National Economic Council Director Gary Cohn stated that the standard deduction would rise to $12,000 for single individuals and $24,000 for married individuals – amounts slightly less than double the standard deductions currently allowed in 2017. The proposed income tax plan does not address whether taxpayers will still be allowed a deduction against taxable income for personal exemptions. During his campaign, President Trump indicated a desire to eliminate the personal exemption deduction as part of his tax plan.

Itemized Deductions: All itemized deductions would be eliminated except for mortgage interest and charitable contributions. Confirmed during the press briefing was the fact that the deduction for state and local income taxes would be eliminated. This has already led to comments by representatives of states that have high income taxes such as New Jersey. Rep Leonard Lance, R-NJ said he would "be a leading voice in negotiations for maintaining that deduction." The proposed income tax plan is silent as to whether current charitable and mortgage interest rules and limitations would still apply.

Alternative Minimum Tax: The tax reform plan would also eliminate the alternative minimum tax for individuals. If the deductions 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.

Child and Dependent Care: The tax reform plan indicates it provides tax relief for families with child and dependent care expenses, but does not offer any details.

Estate Tax Proposals

Estate Tax: President Trump's proposed tax plan eliminates the federal "death" tax. During the press briefing, the "death" tax was referred to as the estate tax. Traditionally, the federal estate tax has worked in conjunction with the federal gift tax on the transfer of assets from an individual to others both during life and at death. The proposed tax plan does not indicate an intention to repeal the gift tax (applicable to an individual's transfers during life). Further, the proposed plan does not mention repeal or reform of the generation-skipping transfer tax. As of now, there remains uncertainty as to whether individuals would be allowed any lifetime, tax free exemptions or exclusions from the gift or generation skipping tax. Another question raised by the elimination of the estate tax is whether or not assets would still be stepped up to fair market value at death.

From a planning perspective, we do not yet know how states with estate and/or inheritance taxes will react to the repeal of the federal estate tax. It is uncertain as to whether states will see this as an opportunity to expand their estate tax base (or to create an estate tax where one does not currently exist) or if the proposed plan will lead to a rethinking of tax on asset transfers.

Domestic Corporate Tax Proposals

Corporate Tax Rate Reduction: President Trump's proposed tax reforms include a reduction in the top corporate tax rate from 35% to 15%. A reduction to the corporate income tax rate may make the US more competitive in attracting investments from foreign businesses. Further, it may help to reduce the incentive that multinational corporations currently have to book their profits offshore.

Flowthrough Rate Reduction: President Trump's proposal also calls for a 15% tax rate to apply to all income earned through partnerships, LLCs, S Corporations, and similar flow-through entities. The rate reduction would reduce the federal income tax burden on many small businesses in an effort to spur both job growth and the economy.

The proposal leaves open the question of exactly what types of income would be eligible for the reduced 15% rate. Left unchecked, a reduced rate for flowthrough income could create strong incentives for taxpayers to hold investments or earn income through a flowthrough entity in order to take advantage of the reduced rate. Administration officials suggested that provisions would be put in place to prevent abuses of the reduced rate structure.

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 owners of flowthrough entities.

International Corporate Tax Proposals

Two of the proposed reforms target the international tax field: (i) introduction of the territorial tax system in the U.S. and (ii) a proposal for a one-time tax on repatriation of profits into the U.S. The outline of the tax reform is silent on whether the territorial taxation principle would equally apply to U.S. individuals who are currently taxed on a worldwide basis.

Territorial Tax System: Today, U.S. businesses are taxed in the U.S. on both their domestic and foreign profits. They are allowed to utilize foreign tax credits to reduce, but not to completely eliminate U.S. taxes on their foreign profits. This worldwide principle of taxation is often subject to heavy criticism by U.S. multinationals. Arguably, it has caused the U.S to be less attractive for international businesses and pushed them to retain massive cash resources overseas. The territorial taxation principle would supposedly mean limiting taxation of U.S. companies to their domestic operations, while income derived from the activities abroad would be subject to tax only in foreign jurisdictions. The proposed reform aims at elimination of this constraint, and further encourages the businesses to return the cash back to the U.S. with a reduced one-time tax upon repatriation. The reform does not address taxation of U.S. operations of foreign corporations.

While the proposal may be an encouraging sign for big business, it is unclear how the territorial approach would affect the existing tax legislation and the application of tax treaties currently in force. For example, all of the U.S. tax treaties were negotiated by the U.S. based on the notion of worldwide taxation. This principle affected the drafting and implementation of the articles governing the elimination of double taxation, the mechanics of foreign tax credit, source of income provisions, limitation on benefits clauses, as well as inclusion of the "savings" clauses that essentially allowed the U.S. to disregard tax treaty provisions when applied to U.S. citizens or permanent residents. It is possible that revamping the tax code and implementing the territorial system would render many tax treaties ineffective or put their application to the corporate world in limbo until such time as the treaties are re-negotiated.

Repatriation of profits: The proposed plan contains a one-time tax on repatriated earnings. The rate of tax on the repatriated assets is currently unknown, but Treasury Secretary Mnuchin indicated that "it will be a very competitive rate that will bring back trillions of dollars."

The plan released on Wednesday is the Administration's attempt to start the tax reform process. The timing of the passage of any tax bills is not certain at this point, nor is the effective date of any potential changes to the tax law. One potential impediment to the passage of tax reform is its effect on the deficit and whether or not the budget reconciliation process would be utilized. Treasury Secretary Mnuchin predicted economic growth and the elimination of deductions would pay for the tax cuts although others have different points of view.

We will continue to monitor the progress of tax reform legislation. Please contact your Mazars USA LLP professional for additional information.

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