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Update on Federal Tax Reform

On September 27, 2017, the Trump Administration and the Congressional Republican leadership released their "Unified Framework for Fixing Our Broken Tax Code". While feather-light on detail, the Framework offers important guidance on the possible direction of federal tax reform. This newsletter highlights certain significant changes for individual taxpayers that are set forth in the Framework.

Income Tax Rates

The Framework calls for three rates of 12%, 25% and 35%, compared to the current seven rates ranging from 10% to 39.6%. There is, however, no indication of the income level at which each rate takes effect. Moreover, the Framework states that a fourth higher rate might apply to the "highest-income taxpayers" so that the new law remains "at least as progressive" as the current law. Our guess is that the fourth rate, if there is one, could end up being 38.5%, ten percent above the otherwise applicable 35% top rate (the current 39.6% top rate came about in the Clinton years as a ten percent surcharge on the then otherwise applicable top rate of 36%). A top rate equal to the current top rate cannot, however, be ruled out.

Clearly intended to defuse Democratic criticism, the possibility of a fourth rate is an ominous sign for high income earners. At this point, even if the fourth rate is somewhat less than the current top rate of 39.6%, such earners should not assume that they will benefit from meaningful tax reduction. However, as discussed later, owners of pass-through entities may still see real relief.

Since the Framework does not address the issue, the top rate applicable to qualified dividends and long-term capital gains is likely to remain 20%. The 3.8% net investment income tax is also likely to stay on the books. This tax is particularly burdensome because in addition to applying to preferentially taxed income such as qualified dividends and long-term capital gains, it applies to investment income taxed at regular rates, such as short-term capital gains, interest, royalties and REIT dividends.

Itemized Deductions

The Framework states that all itemized deductions will be eliminated except those for home mortgage interest and charitable contributions. As a result, the deductions for state and local income, real estate and sales taxes, medical expenses, investment expenses, employee business expenses, casualty losses and other currently deductible items will all be eliminated.

Since there are still a reasonable number of House Republicans from states with high income taxes, such as New York and California, and since some states with high real estate taxes have heavy Republican representation in Congress, such as Texas, we believe that the deduction for state and local taxes will not ultimately be eliminated. However, it may well be cut back, perhaps by capping the dollar amount that can be deducted or by limiting the value of the deduction to the 25% tax bracket (so that those in the 35% or higher tax bracket do not fully benefit from the deduction). Another possible approach would be to phase out the deduction at higher income levels.

It is also possible that medical expenses, which are currently deductible to the extent they exceed 10% of adjusted gross income, may continue to be deductible, although the 10% threshold may be increased.

Other deductions are likely to be completely eliminated. For example, the deduction for investment management fees, which are currently deductible to the extent they and other "miscellaneous" deductions exceed 2% of adjusted gross income, may be dropped. In addition, the deduction for investment interest (such as margin interest on a brokerage account), which is currently fully deductible to the extent of investment income, may be dropped.

Alternative Minimum Tax ("AMT")

In a major simplification, the Framework calls for the elimination of the AMT. In greatly simplified terms, the AMT imposes a flat tax of 28% on all of an individual's taxable income calculated by adding back personal exemptions and certain otherwise deductible items (such as state and local taxes and miscellaneous deductions subject to the 2% floor) and including numerous "tax preference" items (such as the gain inherent in incentive stock options upon exercise). If higher, the AMT applies in lieu of the regular income tax and the graduated rates applicable thereunder, but in all cases qualified dividends and long-term capital gains are taxed pursuant to their special rules.

The interaction of the AMT and possible elimination of the deduction for state and local taxes is an interesting one. High income individuals who have much of their income taxed at 39.6% are unlikely to be subject to the AMT because the 39.6% rate is so much higher than the AMT rate; therefore, elimination of the deduction will increase their federal income tax. However, individuals who are hit by the AMT have, because of the add-back, already lost the benefit of the deduction for state and local taxes, so elimination of the deduction may not increase their tax. But if the deduction for state and local taxes is retained due to political pressure and the AMT is eliminated, these individuals may see a reduction in their federal income tax. Of course, the final shape of the rate structure will have an effect. For example, if the top rate drops below 39.6%, the increase in tax attributable to loss of the deduction will be mitigated for those in the highest bracket.

Retirement Plans

The Framework provides that tax reform will keep the tax benefits that encourage "retirement security" and will aim "to maintain or raise retirement plan participation of workers and the resources available for retirement".

Despite this apparent commitment to tax incentives for retirement saving, there has been much speculation that in order to raise revenue to support lower rates, Congress will scale back the extent to which employees can contribute to 401(k) plans on a before-tax basis. In particular, one proposal would allow participants to contribute up to $9,000 on a before-tax basis but require any additional amounts they choose to contribute to be made on an after-tax "Roth" basis (in 2017 the maximum amount employees can contribute is $18,000, or $24,000 for individuals at least age 50).

This type of approach is especially likely if Congress decides not to eliminate the deduction for state and local taxes, thereby needing revenue from other sources to fund lower rates. Moreover, a limitation on before-tax contributions is arguably consistent with the Framework's stated goal of retaining tax benefits for retirement saving since the investment earnings on Roth contributions can, unlike those on before-tax contributions, be withdrawn without income tax.

Lower Rate for Pass-through Entities

The Framework calls for a 20% rate on C corporations and a 25% rate on the "business income" of pass-through entities (i.e., sole proprietorships, partnerships, limited liability companies and S corporations). It also calls for mechanisms to prevent "wealthy" owners of pass-through entities from avoiding the top individual income tax rate by converting "personal income" into "business income".

The 25% pass-through rate is higher than the 20% C corporation rate because owners of C corporations must pay tax on the dividends paid to them, whereas owners of pass-through entities do not have an additional layer of tax on their profits.

The Framework provides no indication of what is meant by "business income" or what mechanisms will be used to limit the benefit of the 25% rate to business income. Most likely, however, business income will encompass only the income from manufacturing, retail sales and similar activities where labor is only one component of the product being sold, and it will not include income that is the functional equivalent of compensation. As a result, personal service firms, such as those engaged in law, medicine, accountancy, investment management, engineering, architecture, consultancy and the like, will probably not benefit from the 25% rate.

It is possible that political bargaining will result in a rate higher than 25% for higher income pass-through entities. Such an increase is especially likely if a fourth income tax rate for individuals is ultimately adopted. For example, if a fourth rate of 38.5% is adopted, a pass-through rate of 28.5% might apply to larger pass-through entities, thereby keeping a ten percentage point differential between the two rates similar to the differential between the 35% individual rate and the 25% pass-through rate.

Estate Tax

The Framework calls for a repeal of the federal estate tax and the generation-skipping tax. It does not call for a repeal of the federal gift tax, so this tax is likely to stay on the books as a way of preventing individuals from undercutting federal and state income taxes by making significant gifts to family members who are in lower federal income tax brackets or who may live in states with no or low state income taxes.

The Framework does not mention how appreciated property will be treated at death. One possibility is that capital gain tax will be imposed on all appreciated property at death and the heirs will get a step-up in basis equal to the property's then fair market value. Another possibility is that capital gain tax will not be imposed but the heirs will get a carryover of the decedent's basis. A third possibility is that capital gain tax will not be imposed but the heirs of smaller estates will get a step-up in basis (which is the result under current law) but the heirs of larger estates will get a carryover basis. If federal capital gain tax is imposed, it is possible that states that have an income tax but do not have an estate tax will impose their own capital gain tax, potentially increasing the overall tax cost at the time of death.

It should be noted that although they have advocated repeal for many years, Republicans may ultimately decide not to push for it, both in order to defuse Democratic criticism and also to fund other priorities, such as lower rates. In this event, however, it is possible that the lifetime exemption, currently $5,490,000 per person, will be increased, perhaps substantially.

Conclusion

As is readily evident, the Framework provides nothing more than broad-brush guidance as to the contours of tax reform envisioned by the Administration and Congressional Republican leadership. However, the signs to date indicate that apart from owners of certain pass-through entities, high income individuals, especially those with significant amounts of compensation or investment income, may see little in the way of income tax relief and, indeed, may even see an increase in their income tax burden.