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The framework for tax reform

On September 27, 2017, the "Unified Framework for Fixing our Broken Tax Code" was issued. It represents joint Republican efforts from the Trump Administration, the two top Congressional leaders, and the chairs of the House and Senate tax-writing committees to coalesce around tax reform goals and provide a framework for achieving them…while leaving the details to Congress.

Those behind the nine-page Framework are the so-called "Big Six": Steve Mnuchin (Treasury Secretary), Gary Cohn (National Economic Council Director), Paul Ryan (Speaker of the House), Mitch McConnell (Senate Majority Leader), Kevin Brady (Chairman of the House Ways and Means Committee) and Orrin Hatch (Chairman of the Senate Finance Committee). Although months of discussion have led these men to a meeting of the minds on tax reform, others in Congress may disagree – and there is much to resolve. There is also little time in which to do it, since the aim is to get finished tax legislation to President Trump for his signature by the end of the year.

The Framework's tax reform goals include simplicity and fairness, tax relief for middle class families and businesses, and repatriating offshore profits to reinvest in the American economy. It is designed to serve as a template for the tax-writing committees, which are charged with crafting 1) "fiscally responsible" reform by "broadening the tax base, closing loopholes and growing the economy," and 2) "additional reforms to improve the efficiency and effectiveness of the tax laws."

Individual reforms. The Framework proposes the following for individual taxes [the current law references are to 2017 numbers]:

— **Compress the existing seven income tax brackets (10%, 15%, 25%, 28%, 33% 35% and 39.6%) into three brackets: 12%, 25% and 35%**

Comment. The Framework says 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 one and does not shift the tax burden to lower- and middle-income taxpayers. In other words, the decision about a higher

possible top rate rests with the tax-writing committees, as does establishing the income ranges to which these rates would apply. This latitude gives Congressional tax writers flexibility in how they structure and pay for tax reform; yet until there is actual draft legislative language, it is impossible to make apples-to-apples comparisons between the proposed system and the existing one.

— **Roughly double the standard deduction from $12,700 (married joint filers) and $6,350 (single filers) to $24,000 for married joint filers and $12,000 for single filers**

Comment. Taxpayers who don't itemize their deductions take the standard deduction; they are entitled to an additional standard deduction of $1,550 if they are over 65 or blind (or $3,100 if they are both). Taxpayers are also entitled to a **"personal exemption"** (or deduction) of $4,050 for each of themselves, their spouse and their dependents (such as children); these exemptions are phased out, and fully eliminated if taxpayers have "too much" adjusted gross income (AGI): the exemptions completely disappear at AGI of $436,300 (married joint filers) and $384,000 (single filers). To simplify the tax rules, the additional standard deduction and personal exemptions will be consolidated into the larger standard deduction, which the Framework says effectively creates a larger "zero tax bracket."

— **Use a "more accurate measure" of inflation for purposes of indexing tax brackets and tax parameters**

Comment. Currently, inflation-adjusted tax numbers rely on the standard CPI-U, or consumer price index for urban consumers. There has been talk of a "chained" consumer price index, which assumes that if there's inflation, consumers will buy cheaper goods instead of the more expensive ones they used to buy; such an index would make for slower (and smaller) inflation adjustments, and is presumably the measure to which the Framework is alluding. Such a revised measure would likely help reduce the cost of this tax package.

— **"Significantly" increase the child tax credit & provide new $500 credit for non-child dependents**

Comment. Under current law, eligible taxpayers can take up to a $1,000 credit for a "qualifying child" (this term has various requirements, and generally refers to a dependent child under age 17 for whom the taxpayer can also take a personal exemption). The credit is phased out if the taxpayer has modified AGI above a certain amount (e.g., $110,000 for married joint filers and $75,000 for single filers). How much higher the credit will be, along with the higher income thresholds at which the credit will start to phase out, are again left to the tax-writing committees, which also "will work on additional measures to meaningfully reduce the tax burden on the middle-class."

— **Repeal the alternative minimum tax (AMT)**

Comment. The AMT is a parallel tax system that requires taxpayers to figure their taxes twice; if the AMT exceeds the taxpayer's "regular" income tax, the taxpayer pays that higher amount. Although the AMT originally targeted a handful of wealthy taxpayers, it now reaches deep into the middle class. Taxpayers especially vulnerable to the AMT are those who live in high-tax states and have large itemized deductions for state and local taxes (these are an "add-back" for AMT purposes), or have large families and numerous personal exemptions for their dependents (personal exemptions don't count against the AMT).

— Eliminate “most” itemized deductions

The Framework says that it would retain the deduction for home mortgage interest and charitable contributions – meaning that “most” other itemized deductions (see below) would be eliminated. Secretary Mnuchin and Chairman Brady have separately confirmed that the deduction for state and local taxes (e.g., income and real property taxes) is on the chopping block, as it would help pay for tax reductions elsewhere in the Framework.

Comment. Taxpayers can either “itemize” their deductions, or take the standard deduction (see above). Itemized deductions include those for state and local taxes, mortgage interest, charitable contributions, medical and dental expenses, casualty and theft losses, unreimbursed employee expenses and other miscellaneous deductions. Some deductions, such as for unreimbursed medical expenses, are only available if they exceed a certain percentage of the taxpayer’s AGI; all itemized deductions – *except for* medical expenses, investment interest, and casualty, theft and wagering losses – are subject to a “haircut” if the taxpayer has “too much” AGI. For taxpayers who itemize, their largest deduction is typically for state and local taxes; eliminating this deduction would help pay for the proposed tax cuts. This proposal is controversial, however, and the deduction’s supporters are gearing up to fiercely defend it, including House Republicans whose constituents would be adversely affected by the deduction’s elimination.

— Work, education and retirement – retain benefits but simplify and improve

The Framework says that while it retains tax benefits that “encourage work, higher education and retirement security,” it encourages the tax-writing committees to “simplify these benefits to improve their efficiency and effectiveness. Tax reform will aim to maintain or raise retirement plan participation of workers and the resources available for retirement.”

Comment. Although the Framework offers no specific guidance on these goals and directives, the “Rothification” of retirement accounts may be under consideration. To explain, the Roth IRA is funded with “after-tax” dollars (wage income on which income tax has already been paid); when Roth IRA account dollars (including earnings) are withdrawn in retirement, they are tax-free. If retirement accounts such as 401(k)s were “Rothified,” the taxpayer’s ability to fund the account with “pre-tax” dollars (wage income on which income tax has not yet been paid) would be limited or eliminated.

Such a Roth-type approach would presumably simplify and streamline retirement accounts, but it could also result in lower worker participation in retirement savings. That is, workers with ample cash-flow would simply fund their retirement accounts with after-tax rather than pre-tax dollars, whereas workers with limited cash-flow, for whom pre-tax contributions are already a stretch, could find that retirement savings are out of reach.

— “Other provisions affecting individuals”

Comment. The Framework states that “numerous other exemptions, deductions and credits for individuals riddle the tax code,” and envisions repealing many of them to make the system “simpler and fairer for all families and individuals, and allow for lower tax rates.” Which provisions might be in the crosshairs? That is for the tax-writing committees to decide.

— **Repeal the "death tax" and the generation-skipping transfer tax**

Comment. The estate tax ("death tax") and the generation-skipping transfer tax (GST) are two of the three possible taxes on the gratuitous transfer of property (the third is the gift tax). The estate tax applies to transfers at death, the GST applies to transfers during life or at death to people such as grandchildren (either outright or in trust), and the gift tax applies to lifetime transfers.

Under current law, individuals can protect $5.49 million worth of property from gift and estate taxes and GST, or $10.98 million per married couple (special planning is required for married couples to take full advantage of their collective $10.98 million GST exemption). Next year, the exclusion is projected to be $5.6 million, or $11.2 million per married couple. In other words, the taxpayers who would benefit by the repeal of the estate tax and GST are those with assets north of $11 million (for married couples).

The Framework's silence regarding the gift tax and the current rules that allow a stepped-up basis for a decedent's appreciated property perhaps suggest that both provisions would remain (the basis step-up wipes out built-in capital gains, and the gift tax serves as a backstop to the income tax).

Business tax reforms. The Framework states that small businesses "deserve a significant cut," since they drive our economy and our communities; our outdated tax code also costs U.S. workers jobs and higher wages. Here is what the Framework proposes for business taxes:

— **Maximum 25% rate for the "business income of small and family-owned businesses" conducted as sole proprietorships, partnerships and S corporations**

The Framework "contemplates that the committees will adopt measures to prevent the recharacterization of personal income into business income to prevent wealthy individuals from avoiding the top personal rate."

Comment. Currently, sole proprietors and those who receive income distributions from entities such as partnerships and S corporations (so-called "pass-through" entities) report that income directly on their personal income tax return, where it can be subject to a top rate of 39.6%. The Framework aims to change that, and lower the top rate to 25% for the "business income of small and family-owned businesses." The legislative definitions for these terms must be carefully drafted to eliminate the possibility that the income of, say, service providers (such as doctors, lawyers and accountants) would be eligible for this lower rate.

— **Reduce the corporate tax rate to 20% and repeal the corporate AMT; consider methods to reduce "double taxation of corporate earnings"**

Comment. The current top rate for corporations is 35%, which is higher than the 22.5% average rate of the industrialized world. Although many corporations pay a lower effective rate of tax than 35% because of various tax benefits, the 35% rate is viewed as high and largely responsible for jobs leaving the U.S. and companies "parking" their profits offshore; a 20% rate is designed to address this issue. The reference about reducing the "double taxation" of corporate earnings presumably is referring to the following: corporations pay tax on their earnings, which are then passed along to shareholders by way of dividends, which are also taxed to the shareholder. How that deemed double taxation would be addressed is again left to the tax-writing committees.

— **Full "expensing" of capital investments for five years**

The Framework would allow businesses to immediately write off (or "expense") the cost of "new investments in depreciable assets other than structures made after September 27, 2017, for at least five years" – an "unprecedented" level of expensing for eligible assets. The tax-writing committees may continue to work to enhance such expensing for business investments, especially to help provide relief for "small businesses."

Comment. To "expense" an asset is to get an upfront deduction for its cost, rather than recouping that cost over time by depreciating the asset and taking an ongoing (smaller) deduction. Which assets would be eligible for this treatment is again left to the tax-writing committees.

— **Partially limit the deduction for "net interest expense" of C corporations; consider "appropriate treatment of interest paid by non-corporate taxpayers"**

Comment. Companies that rely on borrowing to fund their businesses may object to limiting the interest deduction. It is unclear, for example, what such a provision might mean for farmers who often borrow to help pay for what's needed for new crops ("non-corporate" taxpayers?). Again, it is up to the tax-writing committees to address this.

— **"Other business deductions and credits"**

The Framework states that because of the "substantial" rate reduction for all businesses, "the current-law domestic production ("section 199") deduction will no longer be necessary." In addition, "numerous other special exclusions and deductions will be repealed or restricted," although the research and development (R&D) and low-income housing credits will be preserved.

Comment. Again, details about *which* of the "numerous other special exclusions and deductions" will be repealed or restricted are unspecified, and left to the tax-writing committees.

— **Tax rules affecting specific industries will be modernized to better reflect "economic reality…and provide little opportunity for tax avoidance"**

Comment. Again, the tax-writing committees will be busy filling in the details on this.

The American model for global competitiveness. The Framework says that it puts "America on a level international playing field and puts an end to the incentives for shipping jobs overseas." To that end, it calls for the following:

— **Territorial taxation of global American companies**

The Framework says that it transforms our existing "offshoring" model to an "American model," and ends "the perverse incentive to keep foreign profits offshore by exempting them when they are repatriated to the United States." The current worldwide tax system will be replaced with a "100% exemption for dividends from foreign subsidiaries (in which the U.S. parent owns at least a 10% stake)." To transition to the new system, the Framework treats accumulated overseas earnings as "repatriated"; foreign earnings held in

illiquid assets will be subject to a lower tax rate than those held in cash or cash equivalents. Payment of the tax liability will be spread out over several years.

Comment. This proposal is a seismic shift in how global companies would be taxed. The deemed repatriation of foreign earnings, with its two-tiered tax rates depending on the type of asset is also a big deal, and could bring in a lot of revenue. How this will all be implemented rests, of course, with the tax-writing committees.

— **Stop corporations from shipping jobs and capital overseas**

The Framework says that to prevent companies from shifting profits to overseas "tax havens," it would protect the U.S. tax base by taxing at a reduced rate "and on a global basis" the foreign profits of U.S. multinational corporations. "The committees will incorporate rules to level the playing field between U.S.-headquartered parent companies and foreign-headquartered parent companies."

Comment. Again, it is up to the tax-writing committees to come up with how to implement these goals.

Comments. As is apparent from the Framework's frequent references to the tax-writing committees, legislators have a big job ahead of them to figure out how to accomplish the Framework's goals, including deciding which current tax benefits will be modified or eliminated to pay for these changes. In other words, it's up to the committees to sweat the details and deal with the inevitable political fallout of altering embedded, valuable, and familiar tax benefits. This is a heavy lift under the best of circumstances, and accomplishing this between now and year's end…? Never say never, but it's not going to be easy.

Stated differently, writing tax legislation is hard and takes time, especially when certain carve outs are desired – such as making sure that the special 25% rate for pass-through income is "only" available to small and family-owned businesses. Plus, once the committees issue draft legislation, it's going to be open season as affected constituents mobilize to protect their cherished tax benefits, which are now being eliminated or drastically curtailed.

Can the Administration help mitigate this anticipated onslaught by generating current enthusiasm for the Framework and how it will improve people's lives and grow the economy? Not without more details…and we won't have those until we have draft legislation.

How much will these proposals cost? Without specifics, it's impossible to know. Some budget hawks have said that they believe the proposals could add well over $2 trillion to the deficit, notwithstanding the Administration's assurances that the tax reductions will pay for themselves thanks to the economic growth they will spur. If the Fiscal Year 2018 Budget, which is still being worked on, allows "reconciliation instructions" for up to $1.5 trillion of tax cuts (something that is being discussed), tax writers would have leeway for broad tax cuts, and the legislation could pass the Senate with only 51 votes (it would likely have to sunset after 10 years, however).

When might these proposals be effective? Assuming we get legislation by the end of this year, Secretary Mnuchin has suggested it might be retroactive to January 1, 2017. Again, this is an aggressive timeline for a completed legislative package – and making the changes retroactive would increase the cost of the package.

The Administration and Congressional Republicans are under tremendous pressure to deliver on tax reform, particularly after their failed attempts to repeal and replace the Affordable Care Act (Obamacare). Sweeping tax reform may prove just as difficult.

October 7520 rate

The October 2017 7520 rate is 2.2%, a decline of 0.20% (20 basis points) from September's 2.4% rate. The October mid-term applicable federal rates (AFRs) are also down: 1.85% (annual), 1.84% (semiannual and quarterly), and 1.83% (monthly). The September mid-term rates were: 1.94% (annual), 1.93% (semiannual and quarterly), and 1.92% (monthly).

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