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Proposed Tax Reform - What Should You Do Now?

On September 27, 2017, President Trump announced the release of a "Unified Framework For Fixing Our Broken Tax Code" (the "Framework"). A copy of the Framework can be found at http://src.bna.com/sS3. The Framework was produced by the influential group known as the "Big Six."[1] The stated objectives of the changes outlined in the Framework are (1) to make the tax code simpler and fairer, (2) to reduce income taxes and let workers keep more of their earnings, (3) to make America a magnet for jobs by leveling the international playing field for businesses and workers, (4) to give American companies that are currently keeping trillions of dollars offshore to avoid U.S. taxes an incentive to bring those dollars back to the U.S. and invest them in the American economy, and (5) to eliminate any incentive for U.S. companies to continue stockpiling dollars offshore in the future.

The objectives of the Framework sound great in theory. However, what the Framework means for the future is uncertain. In this issue of *The Passionate Estate Planner*, we hope to provide you with some important initial questions and answers.

Question 1: What changes are proposed by the Framework?

The Framework, as written, is little more than a wish list of desired tax policy changes. It carries very little in the way of specific proposals or details. The following discussion essentially follows the Framework's own language.

A. Personal Income Taxes.

1. The **standard deduction and personal exemptions** will be combined into a larger standard deduction of $24,000 for married couples and $12,000 for single individuals.

2. The **number of income tax brackets** will be reduced and the rates will be changed. The proposal includes three basic brackets, with rates of 12%, 25%, and 35%; however, there is a possibility that a higher bracket will be added for very high income taxpayers. The brackets will be indexed for inflation.

[1] The "Big Six" group includes Treasury Secretary Steven Mnuchin, National Economic Council Director Gary Cohn, House Speaker Paul Ryan, Senate Majority Leader Mitch McConnell, House Ways and Means Committee Chairman Kevin Brady, and Senate Finance Committee Chairman Orrin Hatch. The group members are important because they represent both the Executive Branch (the President and his cabinet) and the Legislative Branch (the majority party in both houses of Congress), and they are likely to have a significant degree of influence over any future tax legislation.

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3. **Personal exemptions for dependents** will be eliminated, but the **child care tax credit** will be increased. A new, non-refundable, tax credit of $500 will be created to help offset the cost of caring for dependents other than children (such as elderly parents).4. The **Alternative Minimum Tax ("AMT") for individuals** will be eliminated.

5. Most **itemized deductions** will be eliminated, but the itemized deductions for mortgage interest and charitable contributions will be retained.

6. **Tax incentives that encourage working, the pursuit of higher education, and saving for retirement** will be retained, and, at least as to retirement savings, possibly improved. However, no specific changes are discussed.

7. **Many other exemptions, deductions, and credits** will be eliminated. Again, no specific changes are discussed.

B. Estate, Gift, and Generation-Skipping Transfer Taxes: the Wealth Transfer Taxes.

The **estate and generation skipping transfer ("GST") taxes** will be eliminated. The Framework does not mention either the gift tax or the rules that currently control the income tax basis of inherited assets (the "step-up-in-basis rules").[2]

C. Business Income Taxes.

1. The **rules regarding the taxation of small and family owned businesses operated through pass-through entities**, including sole proprietorships, partnerships, S corporations, and limited liability companies that are taxed as any of these will change. Business income earned by such entities will be taxed at a maximum rate of 25%. To limit the possibility of abuse, rules will be created so that non-business income will not benefit from the 25% maximum rate.

[2] These rules are commonly referred to as providing a basis step-up because they allow the recipient of many inherited assets to use an asset's fair market value as of the prior owner's death (or, in some cases, an even later date), instead of the deceased owner's original cost basis, as the new owner's basis for income tax purposes. This allows the new owner of an appreciated asset to take a larger basis than the original owner would have had, and wipes out built-in capital gain (or, in some cases, ordinary income) that the original owner would have had to recognize if the asset had been sold before the original owner's death. The step-up-in-basis rules can also cause the loss of basis if an asset has declined in value during the original owner's lifetime, but this effect is often overlooked by professionals and commentators who discuss these issues.

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2. The **rules regarding the taxation of C corporations** will change. These corporations will be taxed at a maximum rate of 20%. The **corporate AMT** will be eliminated.

3. The **rules regarding how investments in depreciable business property** will be deducted (either immediately deducted in full as expenses or depreciated over time) will change. Businesses will be allowed to immediately and fully deduct the cost of depreciable assets other than real estate structures.

4. The **deduction for interest paid by businesses** may be limited.

5. **Two tax incentives for businesses** will be retained, including the credit for research and development expenses and the credit for low income housing. However, **numerous other special exclusions and deductions** for businesses will either be limited or eliminated entirely.

D. International Business Taxation.

The **rules that apply to the taxation of U.S. companies engaging in business overseas** will be changed. The new system will use a territorial taxation approach. The proponents of the Framework believe that the territorial system will be fairer and more in line with the systems used in other countries. They also hope that the changes will reduce or eliminate any incentive for U.S. companies to hold earnings from overseas offshore to avoid paying U.S. taxes on those earnings.

Question 2: Will any Framework-based legislation actually be enacted; and, if yes, when?

Answer: No one knows for sure if and when any legislation will result from the Framework, or whether any such legislation will actually pass and become law. However, we can make some educated guesses.

It does appear quite likely that some kind of final tax legislation will be proposed during President Trump's term in office. It appears even more likely that such legislation will be proposed sooner rather than later; probably before the next Congressional elections take place on November 6, 2018. For one thing, tax law changes were a significant part of the election platforms of the President and many of the Republican members of the House and Senate, and a failure to produce such legislation will be viewed by many supporters as a major failure for the Republican party. For another thing, the Republican party currently holds a majority of both the House and the Senate, as well as the presidency. This means that, if the Republicans can put together tax legislation, they currently have the numbers needed to pass it. If legislation is not proposed and passed before the next Congressional elections, and if those elections result in Republicans losing one or both of their majorities, it may be much less likely that any major tax legislation will be passed.

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One potential block to tax legislation that produces a significant decrease in tax revenue is the fact that increased deficit spending must be specifically approved by Congressional action. As of October 26, 2017, the Senate and House both passed a budget that permits additional deficit spending of $1.5 trillion over the next 10 years. This provision in a new budget would effectively allow any new tax legislation that creates an additional tax deficit of no more than $1.5 trillion over the next 10 years to be enacted with only a simple majority vote, instead of requiring a supermajority, which would be 60 or more in the Senate. As a result, Congressional Republicans may soon be able to effectively create major tax legislation to their tastes, without any input from Congressional Democrats, using a budget reconciliation bill. This is the same strategy that has been used in the past by both parties, with the Republicans using it to pass a couple of major tax acts in early 2001 and the Democrats using it to pass the Affordable Care Act (a/k/a Obamacare).

One of the biggest issues that still has not been resolved is how the potential revenue effect of any proposed tax legislation will be determined by the Congressional Budget Office (the "CBO"). When a tax bill is proposed, Congress asks the CBO to estimate the overall net effect of the bill on tax revenues. This is also known as scoring the legislation. The CBO can use one of two scoring methods: static scoring or dynamic scoring. The results produced by the different methods can differ significantly. Under static scoring, the effective cost of a tax bill is estimated using only the direct tax effects it will produce, and its other potential economic effects are not considered. Under dynamic scoring, both the direct tax effects and other potential economic effects of a proposed bill are considered, including any expected increase or decrease in economic activity. Dynamic scoring tends to produce a more positive overall effect for proposed tax legislation, because expected gains from increased economic activity can be used to offset direct losses in expected revenue from the affected taxes. The CBO tends to use static scoring for most proposed legislation, as this method is easier, quicker, and less expensive to apply than dynamic scoring. However, for major legislation, the CBO will sometimes use dynamic scoring, to try to get a better picture of the overall macroeconomic effect of the proposed bill. We do not currently know which method the CBO would use to analyze a bill that might result from the Framework.

Even if the CBO decides to use dynamic scoring on a proposed tax bill, another factor will be the assumptions it uses to determine the anticipated economic effects of that bill. The Republican party currently believes that tax law changes described in the Framework will significantly increase economic activity. They also believe that the changes will produce at least a 3% annual increase in the U.S.'s Gross Domestic Product ("GDP"). If the CBO were to use the Republican estimates in scoring a Framework-based tax bill, then the overall estimated cost of the bill (the expected net loss in revenue to the federal government) could be quite low, as the expected economic growth would been seen as offsetting most or all of the expected decrease in tax revenue from the existing tax laws. However, most economists appear to feel that these Republican expectations are overly optimistic, and that it is extremely unlikely that any tax

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legislation will be able to produce such a high rate of growth in the U.S. economy. If the CBO decides to use dynamic scoring on a proposed bill, but also uses fairly pessimistic assumptions to predict the overall costs of the bill, the bill could look much more expensive. If the expected net cost of a proposed bill, as determined by the CBO's scoring process, is greater than the amount of additional deficit spending that is allowed by a final budget, then the bill likely will not pass without significant changes, if it passes at all.

Still another factor to consider is that, even though significant tax legislation may be inevitable, it will likely be very difficult for the Congressional Republicans to negotiate and agree upon the final terms of any such tax legislation. The Framework created just that: a framework with very little in specifics. It describes lots of potential tax cuts, but fails make much mention of tax law changes that would increase revenue and help offset the losses created by the cuts. It is far from being anything that could be used as actual legislation, and a lot of work remains to be done before the skeleton provided by the Framework will be fleshed out enough to become an actual proposed bill. The Republican politicians currently in the federal government have not shown a great ability to work together and make compromises with each other, much less with other members of Congress, and it may take enormous quantities of arm-twisting and other forms of persuasion before anything resembling a final bill results.

Finally, we think it is highly likely that, even if tax legislation is actually proposed and enacted, any changes that result will be temporary. This is because the budget reconciliation process that may allow the legislation to pass by a simple majority vote (i.e., without the input of any Congressional Democrats) imposes technical requirements that may require some of the changes to be limited to no more than a 10 year life span. This limitation is the reason that the major tax acts passed in 2001 came with a 10-year expiration date; both acts were passed with a simple majority vote in the Senate and came with tax revenue costs too high to allow them to avoid the 10-year limit.

Last, but definitely not least, Question 3: Should you take any actions (or refrain from taking any actions) based on the proposals set out in the Tax Reform Framework?

Answer: Maybe. Carefully consider the issues discussed in this newsletter. Whether or not you decide to take or refrain from taking any given action will generally depend on your personal situation and what you see as your most likely future.

A. Income taxes. Under the proposals in the Framework, future income tax rates may be lower than current rates, and many existing income tax deductions, exclusions, and tax credits may be eliminated or significantly reduced in value beginning in 2018. For many taxpayers, it may therefore make sense to do what most CPAs recommend in most tax years: in other words, accelerate income tax deductible expenses, excluded income, and tax credit items so that you can take them in 2017, but postpone as much taxable income as possible into 2018 or a later year.

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Some of the most common income tax deductions are for items such as state and local tax payments (usually either income and property or sales taxes), mortgage interest payments, and charitable contributions. Contributions to tax-deferred retirement savings accounts such as qualified plans and IRAs can generate either exclusions, such as contributions to an employer-sponsored qualified plan, which are generally excluded from taxable income, or deductions, such as amounts contributed to a traditional IRA account, which usually generate a deduction for at least a portion of the contributed amounts. While both the mortgage interest and charitable contribution deductions are likely to be retained, at least to some extent, and while incentives to save for retirement are likely to continue to exist, the value of the deductions, exclusions, and credits may be significantly less under the tax regime proposed by the Framework. For example, the Framework proposes doubling the standard deduction. However, itemized deductions, such as the deductions for mortgage interest and charitable contributions, only benefit a taxpayer to the extent that the total of those deductions exceeds the standard deduction. In addition, the Framework hints that the ability to deduct state and local tax payments will be eliminated. If this happens, many taxpayers, especially those in high-tax states, may lose the ability to benefit from any itemized deductions.

As another example, the Framework proposes to continue encouraging people to save for retirement. However, the incentives used may be different. We currently believe that, under the Framework proposals, contributions to accounts for which income tax deductions are currently given in the year of the contribution will no longer be deductible. Instead, the accounts will effectively be treated more like Roth IRAs, where contributions are included in taxable income for the year of the contributions, but where distributions after retirement are income tax free. While this could actually be a positive result for many over the long term if distributions are, in fact, actually eventually received income tax free, things might not work out that way.

Remember, the overall cost of tax legislation is based on the amount of revenue it is estimated to produce over a 10 year period. If that amount is greater than the amount estimated to be produced over the same 10 year period by the existing laws, then the legislation is considered to be a net revenue raiser and can be more easily passed. If the proposed legislation appears likely to produce lower revenue than the existing laws over that 10 year period, however, then it is deemed to be a revenue loser, and it becomes much more difficult, for both technical and political reasons, to pass it. We believe that the proposal to change the timing of the taxation of retirement savings so that contributions are taxable in the year they are made, instead of when amounts are withdrawn years in the future, is intended to make the Framework's overall proposal appear to be a revenue raiser. In other words, this proposal appears to be more an accounting trick than a permanent revenue raiser. If the new laws eventually expire, resulting in contributions becoming deductible or excludible in the year made again, the tax-free status of distributions may well also change automatically, to make the distributions taxable again.

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Even if laws making distributions from all retirement savings accounts tax-free are made permanent at some point, remember that "permanent" in federal government language really only means "until a future government decides to change it."[3] If this proposed change to the taxation of new contributions to retirement savings plans passes, it will likely result in a significant decrease in tax revenues in later years, when plans funded in the near future begin to make tax-free distributions in later years. The resulting decrease in tax revenue will give a future Congress a strong incentive to change the tax laws and impose income taxes on those distributions. There is precedent for such a change: Social Security benefits used to be income tax free to the recipients, on the theory that they were paid for with post-tax contributions by workers before their retirements, but Congress eventually decided to tax a percentage of Social Security benefit payments, at least for those retirees who have income from other sources. For now, it still seems wise to maximize your deductible and excludible retirement plan and IRA contributions for 2017, and to plan on maximizing retirement savings in the future even if the contributions become taxable in the years made. But realize that the overall benefits that may result from taxable contributions could be impacted by future changes to the income tax laws, and that a promise now that distributions will be income-tax-free is not set in stone, and may well be broken.

B. Estate, Gift, & GST Tax Planning.

Experienced estate planners have learned that flexibility in planning is key in an ever-changing world. The Framework proposes eliminating both the estate tax and the GST tax. It does not address either the gift tax or the step-up-in-basis rules. Most commentators appear to believe that the gift tax will likely be retained, to help reduce the potential for higher-income taxpayers to abuse the income tax system by transferring items with significant built-in capital gain or ordinary income to lower-income taxpayers in a free gift, having the lower-income taxpayer recognize the income, and then having the lower-income taxpayer transfer the asset back to the higher-income taxpayer with a new basis and no more built-in income tax issues. However, most commentators also appear to believe that the step-up-in-basis will be eliminated.[4] As with the

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[3] *See, e.g.*, the estate, gift, and GST tax laws, which were made "permanent" by the tax act passed at the end of 2012, but which are now back on the table for repeal or other significant changes.

[4] The theory behind the step-up-in-basis rules is generally thought to be that, because an estate tax applied at the death of the prior owner (even if there were no estate taxes actually paid because the prior owner's estate tax exemption fully covered his or her estate), the new owner should be treated essentially as if he or she purchased the item from the prior owner in a taxable transaction for the value of the asset. Under this theory, if there is no estate tax at the prior owner's death, there should be no change in the basis of the asset when it passes to the new owner, so eliminating the estate tax would naturally call for the elimination of the step-up-in-

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proposed changes to the deductibility or excludability of retirement savings contributions, it appears that the step-up-in-basis may be eliminated to help make the overall Framework look like a revenue raiser and offset the cost of other proposed tax changes.

We have no idea whether these estate and GST tax related aspects of the Framework will be included in any eventual legislation. Based on the current estate and GST tax laws and the related exemptions, less than 1% of the population will likely end up paying any estate or GST taxes. However, the step-up-in-basis rules benefit most people who receive any inheritance at all. That means the proposed elimination of the estate and GST taxes, if combined with the elimination of the step-up-in-basis rules, could cause this Framework proposal to be the clearest indication that the tax legislation will benefit the wealthiest 1% of the population while hurting the other 99%. That could produce a political hot potato. It may be that this portion of the Framework just ends up being used as fodder for negotiation. **However, if Congress is somehow able to eliminate both the estate and GST taxes and still keep the step-up in income tax basis rules, we will be presented with a HUGE opportunity to use trust-based planning to provide tax and non-tax benefits for generations!**

What is the bottom line as what gift and estate tax planning should be done before any proposed tax legislation is enacted? Clearly, you do not want to be the last person to ever actually pay gift taxes. As a professional, you also do not want to the one who is having clients set up inflexible irrevocable trusts or make large, completed, taxable, gifts that the clients may regret if the law is changed and some or all of the wealth transfer taxes are eliminated. For professional advisors and their clients, the key is to continue with necessary and desirable estate and tax planning, while taking steps to maximize flexibility in the planning and avoid making irrevocable transfers that would not be desired if the estate tax ceased to exist.

If you have questions about the Framework and what you may need to do (or not do) with your own planning, we are here to help. Please contact our office administrator at (678) 720-0750 or admin@morgandisalvo.com to schedule an appointment for a consultation.

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basis rules. However, previous attempts to eliminate these rules have failed, because eliminating them is believed likely to produce an administrative nightmare for both taxpayers and the IRS.