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The "Big Six" Federal Tax Reform Proposal

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Tax reform is once again at the forefront of the Washington D.C. political agenda. On September 27, 2017, the "Big Six"[1] released their Tax Framework, which will serve as the blueprint that the Whitehouse and GOP Congressional leadership intend to guide tax reform legislation this year. The stated goals of the Framework are to (1) simplify the tax code, (2) lower the tax burden on working Americans, (3) level the playing field for American business and workers on a global setting, and (4) to repatriate offshore dollars to reinvest in the American economy. While the Big Six Framework is intended to create more momentum for federal tax reform this year, the proposal leaves the detailed drafting to the Congressional tax-writing committees. There is likely to be considerable debate and controversy related to some of the details and enactment of meaningful tax reform in 2017 is far from certain.

A summary of the changes for the taxation of individuals and businesses is set forth below.

Summary of Changes for Individuals

There are currently seven federal income tax brackets for individual taxpayers, with the highest bracket set at a 39.6% tax rate. The Framework aims to consolidate these to three brackets, with rates of 12%, 25%, and 35%. The Administration has indicated that it does not necessarily intend to provide for tax reduction for the highest income taxpayers, so it is possible that in any forthcoming legislation, a fourth rate may remain in the vicinity of the current 39.6%.

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The lowest tax rate rises from 10% to 12%, but that increase in tax rate is intended to be more than offset in most cases by doubling the standard deduction. The current standard deduction is $6,350 for single taxpayers, and $12,700 for married taxpayers filing jointly. The Big Six Framework increases the standard deduction for married taxpayers filing jointly to $24,000, and for all other filers to $12,000. However, the personal exemption is eliminated. Taking all of this into account, the so-called "zero tax bracket" is increased for single filers by $1,600 and for married couples with no children by $3,200.

Under the Framework, families with children will lose their personal exemptions for dependents, but there are promises for an enhanced Child Tax Credit. Additional changes making the credit refundable and increasing phase-out limitations are also included.

The Framework attempts to simplify the Tax Code by repealing most itemized deductions, retaining only the home mortgage interest and charitable contribution deductions. Deductions for medical costs, state and local taxes paid, and student loan interest paid would be eliminated. The proposed repeal of deductions for state and local taxes paid is likely to be controversial, particularly in high tax states.

The Framework proposes the repeal of the estate tax and generation-skipping transfer tax, but does not specifically address gift taxes or the stepped-up basis regime that exists under the current Tax Code for property received from a decedent.

Summary of Changes for Businesses

Income from pass-through entities (partnerships and Sub-S corporations) is generally subject to individual rates under the current Tax Code, subjecting many small business owners to much higher rates than the maximum rate for corporate taxes. The Framework addresses this by capping pass-through income at a maximum rate of 25%. The Framework suggests an intent to limit this pass-through rate benefit to bona fide small businesses and family-owned businesses and asks the committees to adopt measures to prevent high earners from re-characterizing personal income as pass-through income.

The Framework also proposes reducing the corporate tax rate to 20% and suggests the committees may also consider reducing the current double taxation of corporate earnings. This rate cut is intended to make U.S. corporations more competitive in a global economy where average corporate tax rates are now generally well under 30%. However, the Framework does not state whether the corporate rate of 20% is a maximum rate or a flat rate.

Another major change is that the Framework allows (for the first 5 years after enactment) businesses to immediately and completely expense the cost of new investments, abandoning the cost-recovery regimes in place under the current Tax Code. The net interest expense for C Corporations is partially limited under the Framework. Furthermore, most business credits and deductions are repealed, but two credits would be retained: research and development and low-income housing credits.

Finally, the Framework calls for a territorial system of taxation of U.S. businesses, and thereby generally eliminating U.S. taxation of foreign business earnings. Furthermore, repatriated foreign profits would be exempted from tax upon return to the U.S. and there would be a 100% exemption for dividends received from foreign subsidiaries of U.S. parents. The Framework also provides for transition to the new system with the taxation at special lower rates of tax for currently accumulated foreign earnings held overseas. The provisions are apparently intended to create an incentive for the repatriation to the U.S. of a considerable amount of accumulated foreign earnings.

Likelihood of Reform in 2017

With the release of the Big Six Framework, the first steps of reform are in place. Historically, tax reform is a long and arduous process, and an overhaul this size seems to be a very difficult task to complete in 2017. The last major tax reform legislation in 1986 took nearly two years before the reform bill was sent to President Reagan. However, the GOP leaders in both the Senate and the House are already working together on consideration of this plan, which increases the chances of a bill moving more expeditiously.

The Tax attorneys at Koley Jessen are keeping a close watch on Tax Reform. Please contact us with any questions.

[1] The "Big Six" include: (1) House Ways and Means Committee Chairman, Kevin Brady; (2) Senate Finance Committee Chairman, Orrin Hatch; (3) House Speaker, Paul Ryan; (4) Senate Majority Leader, Mitch McConnell; (5) Treasury Secretary, Steven Mnuchin; and (6) National Economic Council Director, Gary Cohn.