Published on *The National Law Review* https://natlawreview.com

Framework for Tax Reform

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This morning, the Unified Framework on Tax Reform was released by Republican members of the House Ways & Means Committee, Senate Finance Committee, and the Trump Administration. Some high level summaries and observations follow.

Individual Rates

- Doubles the standard deduction to $24,000 for a married couple filing jointly and $12,000 for a single individual, thus eliminating tax on income at or below these levels.
  - *Observation*: The proposal eliminates most itemized deductions, including state and local taxes, but preserves mortgage interest and charitable deductions. Realtors and the housing industry are concerned that the doubled standard deduction, combined with the elimination of most other itemized deductions, will eliminate the need to itemize mortgage interest deductions for many taxpayers.
- Eliminates personal exemptions but expands the child tax credit.
- Repeals the alternative minimum tax.
- Consolidates the current seven tax brackets into three brackets of 12%, 25% and 35%.
- Leaves open the option of an additional higher top rate for highest-income taxpayers. This is reserved to ensure that after reform, the tax code is at least as progressive as the existing tax code and does not shift the tax burden from high-income to lower- and middle-income taxpayers
  - *Observation*: In tax policy parlance, this is referred to as "distributional neutrality." The Joint Committee on Taxation breaks national individual income into quintiles, and the Joint Committee will issue a report on the tax burden distribution among the quintiles before and after reform. This rate qualification appears to leave open application of the current 39.6% rate for certain income levels or perhaps an even higher rate for upper income levels, as proposed by a former Trump Administration official, in order to redistribute the overall tax burden to the highest quintile.
- Repeals the estate tax and generation-skipping tax.

Small Family-Owned Business Taxation

- A 25% rate will apply to the business income of small and family-owned businesses conducted as sole proprietorships, partnerships, and S corporations.
  - *Observation*: The income of sole proprietorships, partnerships, and S corporations is

reported on the individual tax returns of the owners. Under the Framework, this provision could reduce the tax rate on such business income from 35% to 25%. The rate reduction could be even greater if the optional higher rate applies to the small and family-owned business income.
    - The Framework does not define “small” in the context of this proposal. We anticipate it could be capped by income levels or by reference to Small Business Administration standards.
    - The Framework contemplates that the tax-writing committees will “adopt measures to prevent the recharacterization of personal income into business income to prevent wealthy individuals from avoiding the top personal tax rate.” This will be a difficult distinction to legislatively define, particularly for businesses where the owners materially participant in the business.
- The tax-writing committees are directed to create “unprecedented expensing for business investments, especially to provide relief for small businesses.” See further details below.

Corporate Taxation

- The Framework reduces the corporate rate from 35% to 20%.
- Corporate AMT is repealed.
- The committees are directed to “reduce the double taxation of corporate earnings.”
    - *Observation*: Reducing the double taxation of corporate earnings refers to Senate Finance proposals on corporate integration. The leading proposal is a partial deduction for dividends paid to shareholders. Covington and the Alliance for Savings and Investment have formed the leading coalition on the partial deduction for dividends paid.
- The Framework allows businesses, including C corporations, sole proprietorships, partnerships, and S corporations, 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.
    - It is unknown whether “depreciable assets” will be defined under the current provisions of sec. 167.
- Interest expense deductions of C corporations will be partially limited.
    - This limitation is unrelated to whether the C corporation has claimed a deduction for fully expensing new depreciable assets.
    - The tax-writing committees are instructed to consider the appropriate treatment of interest paid by non-corporate taxpayers.
    - It is an open question whether this deduction limitation will apply to debt incurred prior to enactment of this partial deduction disallowance.
- The Framework moves to a territorial tax system that provides a 100% exemption for dividends from “foreign subsidiaries (in which the U.S. parent owns at least a 10% stake).”
    - *Observation*: It is unclear whether territoriality will be limited to foreign subsidiaries of C corporations, nor does it address the treatment of foreign branches under a territorial system.
    - Mandatory repatriation: In transitioning to a territorial system, the pre-enactment unrepatriated foreign E&P accumulated under the worldwide systems will be taxed in a manner similar to the 2014 mandatory repatriation proposal of then-Ways & Means Chairman Dave Camp. Accumulated foreign E&P held in illiquid assets (e.g. property, plant, and equipment) will be subject to a lower tax rate than foreign earnings held in cash or cash equivalents. Payment of the tax liability will be spread out over several years. The Camp proposal spread the payments over eight years.

- Base erosion provisions. The Framework proposes "taxing at a reduced rate and on a global basis the foreign profits of U.S. multinational corporations."
  - *Observation*: This statement appears to endorse a minimum tax on foreign earnings of US-based companies, without deferral and without regard to the Subpart F nature of those foreign earnings, but is unclear on the scope, and what continuing role, if any, the current subpart F rules will play under the revised tax system, for example, in the case of investment income.
- The committees will "incorporate rules to level the playing field between U.S.-headquartered parent companies and foreign-headquartered parent companies." It is unclear what this statement means, but presumably equal treatment for full expensing and interest expense limitations would be a starting point.

Other Deductions & Credits

- The R&D credit will be retained.
- The low-income housing credits will be retained.
- Tax-writing committees will determine whether additional credits should be repealed.
- The Sec. 199 deduction, which effectively provides a 3% rate reduction for manufacturing activities, will be repealed as no longer necessary under a 20% corporate tax rate.

We anticipate legislative action on the Framework proposals will begin in October 2017.

National Law Review, Volumess VII, Number 270