Some Quick Thoughts on the "Big Six" Unified Framework

Article By:

David S Miller

Yesterday, the Trump Administration, the House Committee on Ways and Means, and the Senate Finance Committee proposed a "unified framework" for tax reform. The members of the working group are House Speaker Paul Ryan (R-WI), Senate Finance Chairman Orrin Hatch (R-UT), Senate Majority Leader Mitch McConnell (R-TN), House Ways and Means Chairman Kevin Brady (R-TX), Treasury Secretary Steven Mnuchin, and National Economic Council Director Gary Cohn. These individuals are known as the "Big Six".

The framework would (i) condense the individual tax rates into three brackets with a reduction of the highest rate from 39.6% to 35%, (ii) nearly double the standard deduction, (iii) eliminate most itemized deductions (including, presumably, the state and local tax deduction), but retain mortgage interest and charitable contribution deductions, (iv) repeal personal exemptions and increase the child care tax credit, (v) repeal the individual alternative minimum tax, (vi) dramatically reduce the corporate tax rate from 35% to 20%, (vii) allow expensing for capital investments (but not buildings) purchased in the next five years, (viii) disallow a portion of corporate interest expense, (ix) introduce a territorial tax system with a minimum tax on foreign earnings, and (x) provide for a special 25% pass through rate. The framework is only a framework, and very few details were revealed. However, if enacted in its current form, commentators have suggested that the framework would increase the deficit by several trillion dollars.

Individual Tax Proposals

Three Tax Brackets. The framework would consolidate the current seven tax brackets to three – 12%, 25%, and 35%. Thus, the framework would increase the lowest tax bracket from 10% to 12% and reduce the top tax bracket from 39.6% to 35%. However, the framework authors assert that by reason of the larger standard deduction, increased child tax credits (described below), and unspecified "additional tax relief", "typical families" in the 10% bracket "are expected to be better off under the framework." Although the framework would reduce the top tax bracket, it suggests that "an additional unspecified top rate may apply to the highest-income taxpayers." The framework also contemplates a new measure of inflation for purposes of indexing tax brackets.

Increase in Standard Deduction. The framework would nearly double the regular standard deduction from $12,700 for married taxpayers filing jointly to $24,000 (and from $6,350 for single filers to $12,000).[1]

Repeal of Personal Exemptions and Increase in the Child and Dependent Tax Credit. The framework would repeal personal exemptions for dependents and proposes a significant but unspecified increase in the child tax credit (the House Republicans had previously proposed a $1,500 child care credit). The first $1,000 of the credit would be refundable (as under current law), and the framework would increase the phase-out levels for the credit, making it available to higher income taxpayers.[2] The framework also would provide a non-refundable credit of $500 for non-child (e.g., elder) dependents.

Repeal of State and Local Tax and Other Itemized Deductions. The framework would repeal most itemized deductions, including, presumably, the state and local tax deduction, but would retain the home mortgage interest and charitable contribution deductions.

Repeal of the Individual Alternative Minimum Tax. The framework would repeal the individual alternative minimum tax.

Retention of 401(k)s, IRAs and 529 Plans. The framework would retain work, education and retirement tax benefits, which presumably means that 401(k) plans, individual retirement accounts, and 529 education savings accounts would remain intact – but the framework leaves open the possibility that these programs may be revised in some fashion. For example, 401(k) plans could be subject to “Rothification”, meaning that taxpayers would not be able to exclude contributions to a 401(k) plan from tax in excess of $2,500 or $5,000, but distributions from the 401(k) plan would be tax-exempt.

Repeal of Other Unspecified Exemptions, Deductions, and Credits. The framework contemplates the repeal of “numerous” but unspecified exemptions, deductions and credits for individuals. The largest of these is the exemption of employer-paid premiums for health insurance, but there is no specific suggestion in the framework that this exemption will be repealed.

Repeal of Estate and Generation-Skipping Transfer Tax. The framework repeals the estate tax and the generation-skipping transfer tax but presumably retains the gift tax. The framework does not discuss whether assets transferred at death would not be subject to income tax and entitle heirs to a stepped-up basis (as under current law), be treated as sold (and subject to income tax), or whether heirs would receive them with historic basis (and not a step-up basis), each of which has been suggested.

Business Tax Proposals

20% Corporate Tax Rate. The framework reduces the corporate tax rate from 35% to 20%, and “aims” to repeal the corporate alternative minimum tax. The 20% rate is the same rate previously proposed by the House Republicans, and is lower than the 15% rate that President Trump had previously proposed. The framework also suggests that corporate integration (to eliminate the second level of tax on dividends) is under consideration.

25% Pass-Through Rate. The framework proposes a 25% maximum tax rate on the “business income” of “small and family” pass-through businesses (i.e., sole proprietorships, partnerships and S corporations). The framework contemplates that Congress would adopt rules to “prevent the recharacterization of personal income into business income to prevent wealthy individual from avoiding the top personal tax rate.” However, the framework provides no details as to what these rules would be and to whom they would apply.

Expensing for Capital Investments (Other than Buildings). The framework would provide for expensing for new investments in depreciable assets (but not "structures") made after September 27, 2017. Expensing would be permitted for at least five years (but then may sunset). The framework suggests the possibility of other measures for small businesses.

Limit on Interest Deductions Incurred By C Corporations (and Possibly Other Businesses). The framework proposes a partial (but unspecified) limitation on net interest expense deductions claimed by C corporations, and contemplates the consideration of unspecified limitations for non-corporate taxpayers.

Repeal of Domestic Production Deduction and Possible Other Business Tax Credits. The framework proposes a repeal of the section 199 domestic production deduction and the repeal or restriction of "numerous other special exclusions and deductions." The research and development credit and low-income housing tax incentives would be retained. The framework suggests the repeal of other unspecified business tax credits.

Territorial Tax System. The framework proposes a territorial tax system in the form of a 100% exemption for dividends from a foreign subsidiary in which a U.S. parent owns at least 10% of the equity. The framework contemplates an automatic deemed repatriation of accumulated foreign earnings at unspecified rates that will be lower for illiquid assets. Payment of the tax liability associated with repatriation would be over several years, but with no specifics as to how that would be affected.

Minimum Tax for Foreign Earnings. The framework contemplates a minimum tax at a reduced rate on the foreign income of U.S. multinationals. This proposal was not in the earlier House Republican or Trump proposals.

Unspecified "Modernization" of Tax Treatment for Certain Industries and Sectors. The framework contemplates an unspecified "modernization" of the tax rules for certain industries and sectors that "better reflects economic reality" and "provide little opportunity for tax avoidance." No specific industries or sectors are mentioned.

Discussion

Progressivity. By reducing the top marginal rate from 39.6% to 35%, allowing a 25% pass through rate, and by reducing the corporate tax rate to 20%, the framework would provide a significant net tax cut to the top 0.1% and 1% individual taxpayers, and this tax cut would likely be much greater than for any other decile. Although the framework suggests the possibility of a higher rate for individuals to ensure that the framework is at least as progressive as the existing tax code, even with a higher individual tax rate than under current law, it is likely that the wealthiest taxpayers will benefit most.

25% Pass-Through Rate. The parameters of the 25% pass through rate are uncertain, but it is highly likely that it would principally benefit high-income taxpayers. It could also provide a competitive hiring advantage to companies that are organized as pass-throughs rather than corporations (because the flow-through companies would be able to provide the 25% pass-through rate, rather than the 35% ordinary income rate, for compensation paid to their highly paid employees and executives). It could also popularize the "Up-C" structure, a two-tier ownership structure in which public investors own stock in a parent corporation that in turn owns interests in an operating partnership also owned by the company's founders and certain other executives. Existing C corporations could possibly reorganize into Up-C structures to effectively compete for talent.

Denial of Interest Deductions. The “partial” denial of net interest deductions (along with the minimum tax on foreign earnings) will likely be among the most controversial proposals within the business community, and could be among the most difficult to administer.

20% Corporate Tax Rate. The 20% corporate tax rate is lower than was expected, and could reasonably be expected to be increased.

Minimum Tax on Foreign Earnings. The most surprising proposal is the proposed minimum tax on the foreign earnings of U.S. multinationals. It also is likely to be controversial because it could be seen as undercutting the territorial tax system proposal. A territorial system without a minimum tax or a much stronger subpart F regime would allow U.S. multinationals to shift their profits to low tax jurisdictions and permanently avoid all U.S. tax with respect to them.

---

[1] Under current law for the 2017 tax year, the standard deduction is $6,350 for single taxpayers and $12,700 for joint return filers, with an additional standard deduction for the aged or blind. Section 63. The personal exemption is $4,050 per individual, subject to a phase-out beginning with adjusted gross incomes of $261,500 or more for single taxpayers. Section 151.

[2] Under current law, the credit starts phasing out for single filers earning more than $75,000 and for joint filers earning more than $110,000. Section 24(b). To the extent the child tax credit exceeds the taxpayer’s tax liability, the taxpayer is eligible for a refundable credit equal to 15 percent of earned income exceeding $3,000. Section 24(d)(B)(i).

National Law Review, Volumess VII, Number 272