Deciphering the White House tax plan

What's included, what's missing, and what it means for your business

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When the White House announced its plan to reform U.S. tax code last month, the lack of details in the one-page plan was surprising. But, by sifting through what's included and what's not, business owners can get a sense of where the administration is leaning in terms of changing the Internal Revenue Code.

LOWERING TAX RATES ON BUSINESS INCOME

One change that seems certain is a tax cut on business income. President Donald Trump's plan dramatically slashes the corporate tax rate from 35 percent to 15 percent. In addition, the plan would lower rates on pass-through business income from the highest individual tax rate of 39.6 percent to 15 percent. "Pass-through businesses" are businesses that are not taxed at the entity level, but rather the owners of the businesses are taxed on their share of the profits, which is reflected on their personal tax return. The types of businesses that can take advantage of this low rate include partnerships, sole-proprietorships, limited liability companies and S corporations.

Lowering the rate on pass-through business income will certainly incentivize those with wages or ordinary income to try and figure out opportunities to set up their own pass-through entity in order to take advantage of the lower pass-through business income rate. Opponents to the tax cuts will likely point out that if the above scenario were to occur, it would not be uncommon for CEOs of pass-through entities to pay a lower income tax rate than their secretaries.

With this incentive also comes greater responsibility, including additional compliance requirements, such as making estimated payments to the IRS as well as navigating the complex operating rules associated with pass-through businesses. Those seeking to establish LLCs or partnerships should also be aware of changes in the IRS procedure of auditing of partnerships under the new Centralized Partnership Audit Regime, which will go into effect on January 1, 2018. (For more MH coverage of the partnership audit rules, click here.)

SIMPLIFYING THE INDIVIDUAL TAX RATE STRUCTURE

In addition to cutting corporate and pass-through business income tax rates, the plan will also simplify the current individual tax structure from seven income brackets to three: 10 percent, 25 percent and 35 percent. While this lowers the top individual marginal rate from 39.6 percent to 35 percent, it will also push more middle class income earners into higher tax brackets, specifically those currently in the 15 percent, 28 percent and 33 percent brackets, depending on whether they meet the new income thresholds (which have yet to be released).

The Trump plan also doubles the standard deduction, from $6,300 to $12,600 for individuals and $24,000 for married filers. The increase in the standard deduction would obviate the need for most filers to itemize their deductions, which would simplify the tax preparation process for most people.

REPEAL OF THE ALTERNATIVE MINIMUM TAX

In addition, the Trump administration has vowed to repeal the Alternative Minimum Tax (AMT). The AMT is a parallel tax system that was intended to prevent higher income tax payers from avoiding tax by taking too many deductions. In practice, however, the AMT tends to affect more and more middle to upper class tax payers each year due to rising inflation.

REPEAL OF THE ESTATE TAX

The tax plan calls for a repeal of the estate tax. There are no details as to whether the step up in basis would remain for estates under a certain amount. The tax plan is silent as to the gift tax, although it is highly unlikely that it would be repealed because it could lead to income shifting and other tax evasion issues.

CHILDCARE TAX CREDIT

The Trump administration is looking to increase the child and dependent care tax credit, which currently tops out at $3,000 for an individual and $6,000 for married filers. It is a nonrefundable tax credit, which means that the taxpayer will not receive a refund for any part of the credit that is greater than the overall tax owed.

FEWER SACRED COWS

Outside of the home mortgage interest deduction and the charitable deduction, there will likely be fewer deductions, credits or preferential tax treatment for special interest groups. For example, the Trump administration has already announced its intent to repeal the state and local tax deduction, a relatively easy target for the administration, given that its repeal would affect mainly taxpayers who live in high-taxed liberal states, such as California, New York, and Maryland, as opposed to President Trump's base in low-taxed conservative states.

The White House has also taken aim at ending the current tax treatment of the "carried interest" or profit share of investors who claim that income as capital gains rather than ordinary income, which results in a lower rate. But, if pass-through business income is only taxed at a 15 percent tax rate to begin with, then repealing the preferential tax treatment for carried interest would likely not make much of a difference for affected taxpayers.

FROM WORLDWIDE TO TERRITORIAL TAXATION

The Trump administration also plans to move from a worldwide tax system to a territorial system. Currently, when a U.S. business or individual earns money overseas, the income is subject to U.S. taxation, although the business or individual would be able to credit against any foreign taxes paid. If the United States transitions to a territorial system, then any income earned overseas would no longer be subject to U.S. taxation. The United States would only tax income earned within its borders. The Trump plan also includes a one-time repatriation tax aimed at businesses with funds overseas.

Also, conspicuously missing, is any mention from the Trump administration of the controversial destination based cash flow tax which would have been one of the revenue raisers put in place to pay for the above mentioned tax cuts. It remains to be seen whether the DBCFT lives on to make it in the bill or whether the controversies surrounding taxing imports and excluding exports proved to be too complicated to make it into the final package.

WHERE ARE THE “PAY-FORS”?

Apart from “growth” and eliminating tax deductions, there doesn’t seem to be any revenue raisers to pay for Trump’s tax cuts. This means that the Trump plan will likely contribute to the federal deficit, raising the ire of fiscal conservatives, who would be needed to pass any tax reform plan if the Republican Party decides not to reach across the aisle for support. Unless Congress changes the budget reconciliation rules, Republicans will either need to find 60 Senate votes to keep the tax cuts in place or include “sunset provisions” that would allow the tax cuts to end after 10 years. It remains to be seen which path the administration will choose to pass their ambitious tax cut plan.

For tax planning and guidance, please contact the McDonald Hopkins tax attorneys listed below.