The President-elect's tax plan

TAX: As with any new tax plan, there are winners and losers.

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Donald Trump's election victory, along with Republican control of both houses of Congress, means that there will likely be big changes in tax law coming soon. Trump will be inaugurated on January 20, 2017, and considering the "100-day rule" (i.e., much of what a president accomplishes is done in the first 100 days), we can expect the tax law changes to be swift. It's unknown, at this time, whether those changes will be effective in the 2017 or 2018 tax years, but it's likely that the effective dates of any changes will be spread over those two years.

In reviewing Trump's tax plans, two points should be kept in mind:

- His tax plans are largely broad-brush, with few specifics. The plan is briefly stated on his website[1] and he didn't fill in many details in his campaign speeches; and
- The House GOP has its own "Better Way" tax reform blueprint.[2] While that blueprint shares some similarities with Trump's proposals, there are also many differences. There will likely have to be compromise if a quick consensus cannot be reached.

Basic individual tax changes

Trump's plan would collapse the current seven tax brackets to three brackets:

Tax rate	Married filing joint	Single
12%	Less than $75,000	Less than $37,500
25%	$75,000–$225,000	$37,500–$112,500
33%	More than $225,000	More than $112,500

Comment

These rates correspond somewhat closely to current rates, with the exceptions of the current 35% and 39.6% rates. For example, the current 25% rate for married filing joint kicks in at taxable income of $75,300, whereas under the Trump plan it woud be $75,000. The 33% rate under current law begins at $231,400, versus $225,000 under the Trump plan. However, under current law there's an in-between rate of 28% that starts at $151,900.

Further changes to basic individual taxation are:

- Personal and dependent exemptions are eliminated;
- The head of household filing status is eliminated; and
- The standard deduction is increased to $30,000 for joint filers and $15,000 for single filers.

Comment

The increase in the standard deduction means that about 60% of taxpayers who currently itemize will no longer itemize. This is likely to remain true as long as mortgage interest rates are low and taxpayers pay relatively little in home mortgage interest.

Also, the increase in the standard deduction will likely mean that most low- to mid-income taxpayers will have a slightly reduced tax burden. However, with the loss of head of household filing status and the loss of exemptions, a single parent will likely pay more, especially if that single parent has more than one dependent child.

EXAMPLE: Bruce is a single parent who has two dependent children. He files as head of household and has salary income of $70,000 and takes the standard deduction.

For 2016, his taxable income is $48,500, consisting of his $70,000 income less three exemptions of $12,150 (3 × $4,050) less his standard deduction of $9,300. He is in the 15% tax bracket. His tax liability is $6,620.

Under the Trump tax plan, his taxable income is $55,000 consisting of his $70,000 income less his standard deduction of $15,000. He is in the 25% tax bracket. His tax liability is $8,875.

Other individual tax changes

Other individual tax changes occurring under the Trump tax plan include:

- Itemized deductions will be capped at $200,000 for joint filers and $100,000 for singles;
- The alternative minimum tax will be eliminated;
- The tax plan specifically eliminates the 3.8% Net Investment Income Tax. However, under other portions of his platform, Trump intends to repeal the Affordable Care Act (ACA). This will presumably also eliminate the 0.9% Additional Medicare Tax, the penalty for not having insurance, the Premium Tax Credit, and other taxes under the ACA; and
- The existing capital gains rate structure (maximum rate of 20%) will be retained "with new tax brackets."

Comment

It is not clear what capital gains rates will be associated with what new tax brackets. Under current law, capital gains are taxed at a 0% rate for taxpayers in the 10% and 15% tax brackets, 15% for the 25%–35% brackets and 20% for taxpayers in the 39.6% tax bracket. Obviously, those tax brackets do not correspond to the tax brackets under Trump's plan.

Child and elder care

The Trump plan puts a great deal of emphasis on child care and elder care, replacing the current Child and Dependent Care Credit with a more complex but broader system.

Eligible taxpayers will get an above-line deduction for child care for children under age 13 and for elder care for a dependent parent.

The deduction would be available to families who "use" stay-at-home parents or grandparents to provide the child care.

There are several limitations on the deduction:

- No deduction is available to taxpayers with "total income" over $500,000 for joint filers or $250,000 for single filers;
- The deduction for child care is limited to four children per taxpayer;
- The deduction for child care is limited to the "state average for a child of the child's age"; and
- For elder care, the deduction is capped at $5,000 per year, indexed for inflation.

For lower-income individuals who would not benefit from the deduction, the plan would offer spending rebates for child care expenses through the Earned Income Tax Credit. The rebate would be equal to 7.65% of "remaining" eligible child care expenses subject to a cap of half of the payroll taxes paid by the taxpayer; in a two-earner household, the cap would be based on the lower-earning parent. This rebate would be available to joint filers earning $62,400 or less, or single taxpayers earning $31,200 or less.

Comment

The child care benefits might significantly offset the increase in tax for single parents noted in the previous discussion and example.

In addition, the plan will create a new Dependent Care Savings Account (DCSA) for the benefit of specified individuals including unborn children. Total annual contributions are limited to $2,000 per year. When established for children, funds remaining in the account when the child reaches age 18 can be used for education expenses.

Comment

It is not clear if there will be a deduction for contributions or whether income in the account will be tax-deferred or tax-free. It seems likely that the accounts will work much like Health Savings Accounts.

To encourage lower-income families to establish DCSAs for their children, the government will provide a 50% match on parental contributions of up to $1,000 per year. Apparently, this government match will be made in the form of a refundable tax credit administered through the Earned Income Tax Credit.

Comment

Eliminating dependent exemptions and the head of household filing status has the potential to eliminate the complex rules that determine who is a dependent and who gets to claim the dependent. However, with the EITC and the child care rules, that difficult determination is still in play. It is not clear at this time whether IRC §152 (Dependent Defined) will be retained along with all of the regulations, rulings, and court cases under that provision.

Business provisions

There are several provisions benefitting business taxpayers. Chief among those provisions is that the plan will lower the "business tax rate from 35% to 15%." Further, this provision provides that "this rate is available to all businesses, both large and small, that want to retain the profits within the business."

Comment

As broad-brush as many of the plan's provisions are, this one is causing considerable speculation. The provision is simple when applied to a C corporation. But the phrase "is available" seems to imply that other business entities may elect to be treated like a C corporation. It would seem to mean that a partnership, for example, may elect to pay a 15% tax at the partnership level with the partners paying tax on distributions. It is not clear at all whether any such election would be made on an annual basis or whether the election, once made, is in effect for all future years.

Moreover, the phrase "all businesses" would seem to indicate that even sole proprietors operating Schedule C business can take advantage of the 15% rate.

Business tax incentives

The Trump plan will raise the IRC §179 expensing cap from $500,000 (adjusted for inflation) to $1 million. Moreover, businesses engaged in manufacturing in the U.S. could make an election to expense all equipment purchases and lose the deductibility of interest expense. The election can only be revoked within the first three years of making the election.

The plan eliminates "most corporate tax expenditures," except for the Research and Development Credit. The phrase "most corporate tax expenditures" is not defined.

The plan also greatly enhances tax benefits for on-site child care expenses and for businesses that pay a portion of an employee's child care expenses.

Death taxes

The Trump plan states: "The Trump Plan will repeal the death tax, but capital gains held until death and valued over $10 million will be subject to tax to exempt small businesses and family farms."

Comment

It is impossible to interpret that sentence because of its many grammatical errors. The final clause beginning with "to exempt" implies that that final clause is the *result of* what precedes it but there's nothing in what precedes it that leads to the conclusion of the final clause. And, strictly read, "valued over $10 million" refers to the amount of capital gains, not the value of the estate. So, does that mean that an estate with built-in gain of $10 million will be taxed and, if so, at what rate and when?

The most common interpretation is that, if an estate has a valuation of more than $10 million, the estate will be taxed on its built-in gains at the capital gains rate of 20%. It appears to be a cliff test. It is assumed that after paying the tax, the heirs will receive the assets at a stepped-up basis.

Another interpretation is that, if the estate has a value of more than $10 million, the heirs will pay tax when they sell the assets. This interpretation means that the heirs receive the assets without a stepped-up basis.

Apparently, if the estate has a value of under $10 million, the heirs receive the assets with a stepped-up basis.

GOP plan

The House GOP's "Better Way" plan shares these similarities with the Trump plan:

- A reduction of the top tax rate to 33% with three tax brackets;
- The elimination of the AMT;
- A larger standard deduction;
- A reduction of the corporate tax rate to 20%; and
- Repealing the ACA and, as a result, the tax provisions that go along with it.

The Trump plan is significantly different from the "Better Way" plan in that it will:

- Continue the EITC but look for ways to improve it;
- Eliminate all itemized deductions except for home mortgage interest and charitable contributions;
- Completely repeal the estate tax; and
- Allow interest expense to be deducted by businesses only against interest income.

Comment

The biggest difference pertains to itemized deductions. Trump wants to limit overall itemized deductions to $200,000 for joint filers and $100,000 for singles. The GOP wants to eliminate all itemized deductions except for home mortgage interest and charitable contributions, but without an overall dollar limit. This difference is especially relevant to high-income taxpayers who make large charitable contributions.

[1] www.donaldjtrump.com/policies/tax-plan

[2] http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf