Tax Plans Compared (December 2016) Individual Income Tax

12.05.2016 | Private Client Alert

It is widely expected that Congress will address tax reform early in its 2017 session. This alert summarizes current law, President-Elect Trump's proposal, and Speaker of the House Paul Ryan's proposal on key individual income tax provisions relevant to high-net-worth individuals. Estate, gift, and generation-skipping tax proposals (including possible changes to the treatment of basis at death) are addressed in a separate Alert.

Current Law

Trump Proposal

Ryan's "A Better Way"

Income Tax Rate Brackets

10%, 15%, 25%, 28%, 33%, 35%, 39.6%

3 brackets: 12%, 25%, 33%

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Capital Gains Tax Rates

0%, 10%, 20%

Same as current law

50% of net capital gains, dividends, interest are deductible

Net Investment Income Tax

3.8% surtax

Repealed

Repealed

Individual AMT

Yes

No

No

Deductions

Standard deduction of $12,600 for married, $9,300 for head of household, $6,300 for single.

For high-income taxpayers, "PEP" eliminates personal exemptions and "PEASE" cuts itemized deductions.

Standard deduction of $30,000 for married, $15,000 for single. Itemized deductions capped at $200,000 for married, $100,000 for single. No personal exemptions. No Head of Household status.

Standard deduction of $24,000 for married, $18,000 for single with children, $12,000 for single. Only itemized deductions allowed are for home mortgage and charitable contributions. No personal exemptions.

Pass-through entity income

Income maintains its character and is taxed on owner's return at owner's rates.

It is unclear whether there will be a reduced rate of tax to individuals on the income of S corporations, partnerships, and other pass-through entities.

Maximum tax rate equal to corporate tax rate (25%) on sole proprietorship and pass-through income from S corporations and partnerships, to the extent it exceeds "reasonable compensation," which will be taxed at regular individual rates.

Current Law

Trump Proposal

Ryan's "A Better Way"

Treatment of Carried Interests

Income maintains its character, which gives fund managers the benefit of long term capital gain rates where applicable

Taxed as ordinary income.

Taxed as ordinary income.

<u>Procedural Hurdles to Passage</u>. There are two procedural rules that could stand in the way of tax reform. Both impact only the Senate consideration of a bill. Right now it takes 60 votes to stop a filibuster. In addition, the Senate might adhere to the "Byrd Rule," which requires a 60-vote majority to pass any bill that has a negative impact on revenue outside of the 10-year revenue window. However, both of these rules are procedural and could be changed in the next Congress.

Even with those rules in place, there are several potential paths to passage. First, a tax reform bill could have sufficient bipartisan support to garner a 60-vote majority. Second, the bill is likely to be in the form of a budget reconciliation act, which is not subject to filibuster. Finally, it would be possible to make the bill revenue neutral in the "out" years (those years outside the 10-year Senate budget window), perhaps by adding a sunset provision like the one in the 2001 tax act. Consequently, we can envision several options leading to enactment of a comprehensive tax reform bill.

Effective Date Considerations. There are several possible effective dates for a tax reform bill. A bill could be effective retroactively to January 1, 2017. Alternatively, a bill passed during the year could be made effective on January 1, 2018, but it seems unlikely that Congress would want a full year to pass without the benefit of the reforms they enact. That raises the possibility of a mid-year, “date of enactment” effective date. The tax code already includes a provision that automatically provides a “blended” income tax rate – a weighted average of the old rates and the new rates – for the year of transition when tax rates change mid year, although Congress could override that in legislation.

Planning Advice. With a substantial chance of rate reductions for 2017, the typical year-end advice to defer income and accelerate losses is even more important this year. In addition, because there is a significant possibility that itemized deductions will be limited in tax reform, we also advise acceleration of deductions, such as payment of 4th quarter state estimated tax, into 2016 (staying mindful of the AMT).

Consideration should be given to accelerating charitable contributions by making early payment on any outstanding pledges. Clients could also fund a donor advised fund from which future charitable contributions could be made.

Caplin & Drysdale’s Private Client attorneys would be happy to assist you with any tax planning needs at this time of uncertainty. Please contact:

Beth Shapiro Kaufman
202.862.5062
bkaufman@capdale.com

Jonathan S. Brenner
212.379.6050
jbrenner@capdale.com

Anne J. O’Brien
202.862.5033
aobrien@capdale.com

Attorneys

Jonathan S. Brenner
(212) 379-6050
jbrenner@capdale.com

Anne J. O'Brien
(202) 862-5033
aobrien@capdale.com

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