Tax Reform Moves to the Front of the Line

Following multiple unsuccessful attempts to reform health care, Washington has turned its focus to reforming the Tax system.

Tomorrow, Republican leaders in Washington are scheduled to release details of their "Unified Framework for Fixing Our Broken Tax Code". The document will provide further details about what the Republicans would like to see. To date, the slim policy outlines that have been released leave many questions unanswered.

According to www.treasury.gov, the four principles of this initiative are as follows:

1. Make the tax code simple, fair, and easy to understand.
2. Give American workers a pay raise by allowing them to keep more of their paycheck.
3. Make America the jobs magnet of the world.
4. Bring back trillions of dollars that are currently kept offshore, thus reinvesting in the American Economy.

To achieve the principles outlined in the Framework, some likely features include:

- Reduction in the number of individual tax brackets from seven down to three: 12%, 25%, and 35%. There seems to be some wiggle room for adding a fourth bracket for very high earners, which may be "at least as progressive as the existing tax code". For reference, the current tax code contains a 39.6% tax bracket.

- Roughly doubling the standard deduction to $12,000 for individuals and $24,000 for couples. This would be a very front-and-center way to help the working class. Raising the standard deduction would theoretically increase the size of the "zero tax bracket" for many workers.

- Eliminating the Alternative Minimum Tax. The alternative minimum tax was created with the intent of making sure wealthy individuals with seemingly low income couldn't avoid paying taxes. The Framework suggests that the Alternative Minimum Tax no longer serves its intended purpose, and instead, creates significant complexity, causing taxpayers to do their taxes twice.

- Eliminating the estate tax. This has been controversial because according to the Joint Committee on Taxation, 99.8% of estates owe no estate tax at all, leaving the estates of 0.2% of the wealthiest Americans to pay up. However, proponents of the Estate Tax Repeal point towards the burden it places on generations who inherit from farmers and business owners who would like to keep the farm or business in the family, but are forced to sell in order to pay the Estate tax.

- Reducing the current top corporate tax rate from 35% to 20%. The cut in corporate taxes would spur growth and create jobs, thus expanding the tax base.

- Providing a path by which companies that do business overseas will be incented to bring trillions of dollars back to the United States.

- Capping the tax rate applied to certain so-called "pass through" entities—such as sole proprietorships, partnerships, and S corporations—at 25%, though uncertainty remains about which types of small businesses would qualify for this treatment.

What about Deductions, Credits, and Incentives?

In addition to the ambiguity surrounding the highest tax bracket, the framework leaves several other key questions unanswered, such as:

What happens to the thousands of tax credits and deductions in the tax code?

The Framework document says it "eliminates most itemized deductions, but retains tax incentives for home mortgage interest and charitable contributions." Each of the tax code's credits and deductions have a constituency that would want to preserve it, so it's likely that this process could stir up a great deal of controversy.

How will investment income be taxed?

The plan framework does not provide any predictions for the tax rates of dividend income and capital gains. It does not elaborate on the future of the Net Investment Income Tax, the 3.8% surtax on investment income for wealthier taxpayers that helps pay for the Affordable Care Act.

Will there be changes to retirement savings incentives?

The framework says only that it "retains tax benefits that encourage work, higher education and retirement security." Despite President Trump's recent tweet suggesting that there will be no changes to 401(k)s, some reports have suggested a reduction in the amount that could be deducted, causing some retirement account contributions to be taxed up front (like a Roth account). This would target higher earning tax-payers who typically have more capacity to fund qualified retirement savings accounts.

How will we pay for the Tax Cuts?

The framework calls for an estimated $5 trillion in tax cuts. Cuts of this magnitude hurt the federal budget and would dramatically increase the federal deficit. Therefore, some of the cuts would need to be offset by increases in revenue (taxes) for the Treasury. The information scheduled to be released tomorrow should provide additional details.

As with most tax-reform discussions, the elements of the proposals typically create winners and losers, and it's likely that heated debates will follow.

HCM will continue to provide updates about the Tax Reform Framework and how it might affect the decisions you need to make as part of your Retirement Income Plan. If you have further questions, please contact a member of the HCM Wealth Advisory Team:

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