Article: Inauguration of President Trump May Result in Major U.S. Tax Changes in 2017

By: Leslie R. Kellogg, TEP, Partner, Hodgson Russ LLP

On January 20, 2017, Donald J. Trump was inaugurated as the 45th President of the United States. On the campaign trail, he consistently highlighted that one of his top priorities was a comprehensive reduction in income and transfer tax rates. That commitment seems to have carried over now that he is officially in office.

Once he took the oath of office, the White House website was immediately updated to highlight the six key issues that his administration will be focusing on: (1) America First Energy Plan; (2) America First Foreign Policy; (3) Bringing Back Jobs and Growth; (4) Making our Military Strong Again; (5) Standing Up for Our Law Enforcement Community; and (6) Trade Deals Working for All Americans. Tax Reform is embedded within the third issue above. The website states, "The President's plan will lower rates for Americans in every tax bracket, simplify the tax code, and reduce the U.S. corporate tax rate, which is one of the highest in the world."

In addition, Congressional Republicans generally have supported comprehensive tax reform that would lower both individual and business tax rates, and would overhaul U.S. international tax rules to be more in line with those of other countries. House Speaker Paul Ryan (R-WI) has said that the Republican-controlled Congress could advance tax reform in 2017 by using "budget reconciliation" procedures that allow legislation to be approved in the Senate with a simple 51-vote majority, instead of the 60 votes generally needed to advance legislation.

Budget reconciliation has been used in the past when one party controlled both the White House and Congress but did not have a 60-vote "filibuster-proof" majority in the Senate. That is the current situation as the Republicans currently control Congress but only hold 52 seats in the Senate. Budget reconciliation bills receive expedited consideration and have special procedural protections that facilitate passage, especially in the Senate, where reconciliation bills cannot be filibustered and require a simple majority to pass.

However, there are several limitations on the use of budget reconciliation in the Senate. One longstanding limitation is the requirement for a 60-vote supermajority to approve provisions that lose revenue beyond the budget window (usually ten years).

While it is unclear at this point what U.S. tax reform may ultimately look like, a look at the tax proposals by both the President and Congress should be instructive.

President Trump Tax Proposals

President Trump has previously proposed large corporate and individual tax cuts that are meant to promote economic growth and domestic investment. These proposals include:

- The top U.S. corporate tax rate would be reduced from 35% to 15%.
- The corporate alternative minimum tax would be repealed.
- Owners of sole proprietorships, partnerships, S corporations, and other pass-through businesses could elect to be taxed on their pass-through business income at the 15% corporate rate rather than individual tax rates.
- The number of personal income tax brackets and tax rates would be reduced. Currently there are seven brackets with a top rate of 39.6%. The proposal is to reduce this to three brackets with a top rate of 33% for income over US $225,000 for married filers.
- Maintain the current highest long-term capital gain rate for individuals at 20%.

- Repeal the entire Affordable Care Act and related taxes, which would include the 3.8% percent net investment income tax.

The Trump tax plan, outlined during his campaign, could also repeal the estate tax, but the language used on his website to describe his proposal raises more questions than it answers. Specifically, Trump's proposal is to:

> "repeal the death tax, but capital gains held until death and valued over US $10 million will be subject to tax to exempt small businesses and family farms. To prevent abuse, contributions of appreciated assets into a private charity established by the decedent or the decedent's relatives will be disallowed."

It is unclear what President Trump intended by his reference to the "death tax". Some commentators believe that this would mean a repeal of the estate and generation skipping transfer tax, but the details of any such proposal remain a mystery as does his administration's view on the gift tax. It is also unclear as to how his proposed $10M capital gain exemption will be implemented. Some believe that this signals a revision to the current provision that allows for assets included in a decedent's estate to receive an income tax basis step-up to the fair market value of the property at the decedent's death. Others have speculated that this could mean an immediate income tax event on death in certain situations.

The President is required to submit a budget by the first Monday in February; however, in the case of a newly elected President, the budget submission is often delayed by several weeks.

House Republicans' Blueprint for Tax Reform

The House Republicans also announced their support for sweeping tax reforms in June of 2016. Under that plan, which has been referred to as the House Blueprint, individual and corporate tax rates would be reduced but, in some instances, not to the same extent that President Trump is proposing. The proposals include:

- The U.S. corporate tax rate would be reduced to 20%.
- The corporate alternative minimum tax would be repealed.
- Owners of sole proprietorships, partnerships, S corporations, and other pass-through businesses would be taxed generally at a 25% rate. Owner/operators would continue to have their "reasonable compensation" taxed under the ordinary income rates described below.
- The number of personal income tax brackets would be reduced from seven to three and the tax brackets would be reduced to 12%, 25% and 33%.
- Individuals would be able to deduct 50% of their investment income (i.e. capital gains, dividends and interest).

The House Republicans' proposal would also repeal the estate tax and is silent on any potential changes to the gift tax. There would also be significant changes to the taxation of business income earned outside the United States. Currently, US corporations are taxed on their worldwide income with the ability to defer paying tax on active business income earned by controlled foreign corporations ("CFCs"). The House Blueprint essentially advocates moving the United States to a territorial tax system which would mean a total revision to the current CFC tax regime.

The Future of the U.S. Estate Tax

In the coming year, of particular interest to U.S. citizens living in Canada (as well as Canadians who own U.S. situs property) will undoubtedly be the long-term future of the U.S. estate tax. Under current law, the 2017 estate and gift tax exemption is US $5.49 million per individual, up from US $5.45

million in 2016. Essentially, this means that every U.S. citizen can leave US $5.49 million to heirs and not pay federal estate or gift tax. Surviving spouses can carry over each other's unused exemptions, allowing a U.S. citizen couple to shield just shy of US $11 million (US $10.98 million) from federal estate and gift taxes. Amounts in excess of these exemptions are taxed at a top rate of 40% which can result in an enormous estate tax liability for high net worth U.S. citizens living in Canada. This tax can be far in excess of his or her Canadian deemed disposition tax exposure which taxes only the appreciation in the decedent's assets, not the entire fair market value at death.

It is also very unclear as to whether the U.S. gift tax will remain or will be repealed as part of a broad repeal of the estate and generation-skipping transfer (GST) tax. While the House Blueprint mentions estate and GST tax but not gift tax, it isn't clear whether President Trump's proposal to repeal the "death tax" was intended as a shorthand reference to all transfer taxes or if he meant to exclude the gift tax from repeal.

Repealing the gift tax has broad implications even beyond the obvious impact such a repeal would have on the transfer tax regime. It can have profound income tax effects in a progressive tax system. Without the back stop of the gift tax, wealthy family members in the highest income tax brackets will be incentivized to make gifts to children or parents in order to shift the income tax burden to individuals in lower brackets. One commentator has estimated that the overall revenue loss to the U.S. federal government over a 10-year period would be US $250 billion if the gift tax were repealed.[1]

All of these factors may result in the U.S. transfer tax system looking a lot more like the Canadian tax system in the year to come. If the estate tax is eliminated, presumably the current rule that allows a step-up in basis to fair market value at death for income tax purposes will need to be altered. The U.S. may end up with essentially a modified deemed disposition tax that taxes the appreciation in assets held at death. Only time will tell, but this is certainly an "interesting" time to be a U.S. tax attorney.

---

1 See "The $250 Billion Price Tag Associated With Gift Tax Repeal" by Jay A. Soled, Tax Notes, January 23, 2017.