TAXES UNDER TRUMP: WHAT IS LIKELY

Q&A WITH KRISTI MATHISEN CPA, J.D.

KRISTI MATHISEN

is LNWM's in-house expert on tax and estate planning issues. She is an attorney and CPA, with more than 25 years of experience.

Tax reform has been on the horizon for many years. In 2017, it might actually happen. For some insight as to why and how, we sat down with Kristi Mathisen, Managing Director of Tax and Financial Planning at LNWM.

Kristi, how likely are tax changes this year?

Kristi: The chance of tax reform is higher than it's been in quite a while. However, the extent of reform is unknown. There are big differences even among the Republicans, let alone the Democrats. And many other actors will have input, especially in regard to the impact on the federal budget deficit.

What we do know: There's significant common ground between the House Republicans' proposal in 2016 (*The Better Way to Tax Reform*) and the latest proposals by then-candidate Trump (as of August 2016). In addition, changes to the Affordable Care Act ("Obamacare") may have an impact on taxes.

What is common ground on the Republican side?

Kristi: In terms of personal income taxes, there are four major areas of common ground. These, I think, can provide a very general blueprint for where changes to our tax code might happen.

- **REDUCE** the number of tax brackets (from 7 down to perhaps 3).
  Why: To simplify the tax code, creating less of a drag on productivity.
- **REDUCE** the highest marginal income tax rate.
  Why: To boost economic activity.
- **RAISE** the standardized deduction, to perhaps double current levels.
  Why: Only 5% of tax returns would then itemize (estimate) vs. 30% currently, simplifying tax prep.
- **REDUCE** or eliminate itemized deductions.
  Why: More economic activity would then be taxed, broadening the tax base. Properly structured, a broader tax base could support lower tax rates while generating about the same amount of tax revenue.

What effect is broadening of the tax base likely to have?

Kristi: Most Americans would probably end up paying lower income taxes, and filing would be simpler and quicker. However, for higher-income households, the benefit of lower rates could be offset by limits on itemized deductions.

The Trump proposal: Restrict the *total amount* of itemized deductions allowed each year – up to $100,000 for single taxpayers and $200,000 for married couples.

The House Republicans' plan: Restrict *the type* of deductions. Allow itemized deductions only for: (1) mortgage interest; and (2) philanthropic donations.

Either of these approaches would affect mostly investors and high-income filers with a high level of itemized deductions. In addition, the Trump proposal could have a negative impact on philanthropy, with high-income households having to choose between deducting, say, $100,000 in state taxes or a $100,000 donation to a charity.

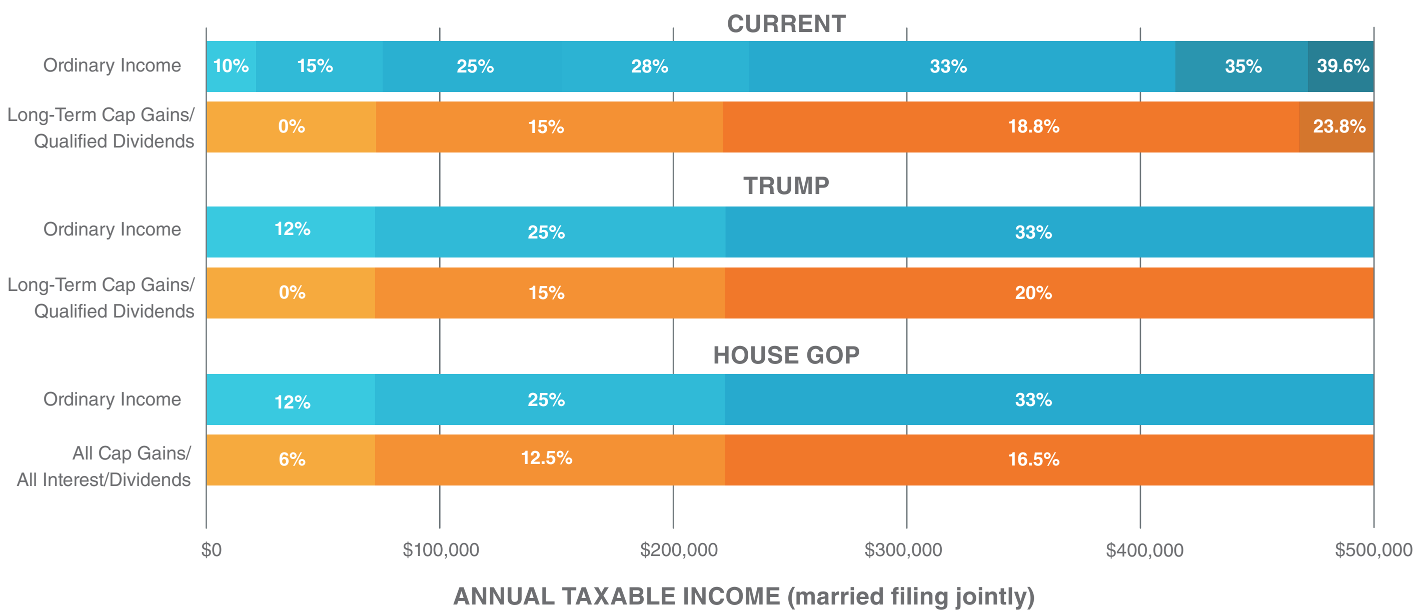
Keep in mind, however, that upper-income Americans would benefit from other key proposals: lower business taxes, estate taxes and investment income taxes, as well as an end to the Alternative Minimum Tax.

Let's start with investment income.

Kristi: The House Republicans' plan calls for a new approach that taxes investment income at the higher rates that apply to ordinary income. Investment income would also be broadened to include interest payments (from bonds, savings accounts, etc.), in addition to capital gains (both long-term and short-term) and dividends from equity investments. But here's the twist: Only half (50%) of investment income would be taxed, effectively cutting the rates on investment income to half those on regular income.

Under President Trump's existing proposal, investment taxes would be closer to where they are now.

Current vs. Proposed Tax Rates



What should business owners be aware of?

Kristi: The headline news has focused on lower corporate taxes to attract off-shore profits back to the US. However, we could see significantly lower taxes on all types of businesses as well.

The House Republicans' plan would tax income from an operating business (not investment company) at a maximum 25% rate. This is much lower than the maximum of 39.6% now being paid by S. Corp. owners, as well as the 46% max paid by owners of sole-proprietorships, partnerships and LLCs (if you include the self-employment tax on net earnings).

Note that the new 25% maximum rate would apply only to business income, not the owners' compensation, which would continue to be taxed as personal income. We're keeping a close watch on how "compensation" will be defined and carved out, since that portion of business income will be subject to higher taxes.

How likely is repeal of the federal estate tax?

Kristi: It is likely, but maybe not in 2017. Both the President and House Republicans want to repeal the estate tax now levied on estates over $5.49 million ($10.98 million for couples). The President's proposal would however tax the capital gains appreciation on estates valued at over $10 million, but it is not clear when that tax would be due and how it would be calculated.

WATCH THE US SENATE

Permanent tax reform requires the support of at least some Senate Democrats, limiting the amount of change possible.

While Republicans have majorities in both the House and the Senate, the Senate majority is by only 1 vote. Therefore, Senate Democrats can filibuster to prevent the passage of tax legislation. A way around this: Republicans attach tax reform to the 2018 federal budget resolution, which would then require a simple Senate majority to pass. The catch is that tax changes passed through Budget Reconciliation expire after 10 years, unless renewed.

Repeal may not happen this year for several reasons: While mentioned, it was not a top priority of the President during the election; it will be fought by the Democrats in Congress as favoring the very rich; and overall tax reform can proceed without it since it currently brings in less than 1% of federal tax revenues.

And the gift tax?

Kristi: The gift tax on annual transfers over a certain amount may very well be kept in place, even if the estate tax is repealed. Gift taxes discourage people from trying to lower their tax bills by giving property to their kids.

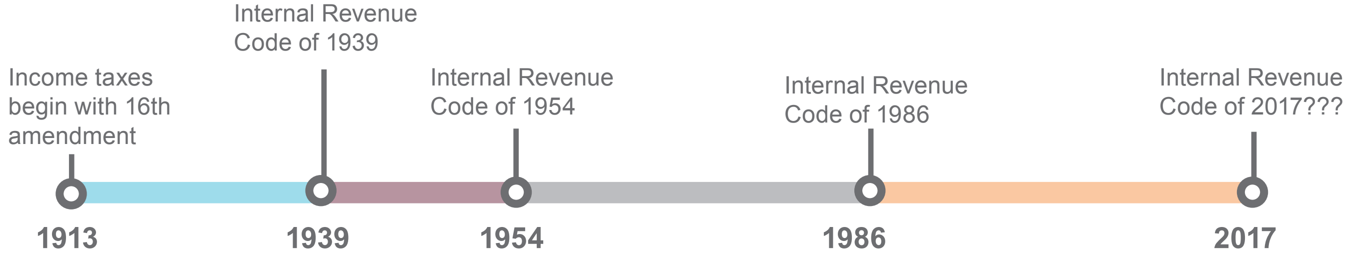
What about the taxes associated with Obamacare?

Kristi: There are more than 20 different taxes levied on companies and individuals to pay for the Affordable Care Act (ACA). Two of these apply to higher-income Americans (married couples with annual income over $250,000, $200,000 for singles):

1. The 3.8% surtax on net investment income; and
2. The extra 0.9% Medicare tax on high-earners' salaries.

I suspect that changes to these taxes may occur later than changes to the health care system – if at all. Repealing and replacing the ACA — a top priority of President Trump and the Republicans — will be an enormous challenge. Making this large of a change without a funding source, such as that already provided by the ACA-related taxes, may be high impossible.

CHANGES TO THE US TAX CODE



SOURCE: Michael Kitces.

If tax reform does pass, will it be retroactive?

Kristi: Income tax changes often have mid-year effective dates. However, large-scale reform is different. The most recent tax reform, in 1986, went into effect the year after - Jan. 1, 1987 - and it was phased-in over several years.

Repeal of the estate tax is likely to be retroactive to the beginning of the year passed, to avoid foul play.

What, if anything, should people be doing now to prepare for tax law changes?

Kristi: Tax change in 2017-2018 is likely. But how much and when it will happen is not. So I would advise not taking any significant actions until we have a better idea of what will happen. In the meantime, we continue to follow tax policy closely and will be reviewing each of our client's financial planning strategies in light of any new changes in 2017.

ABOUT THE AUTHOR

KRISTI MATHISEN is Laird Norton Wealth Management's in-house expert on tax and estate planning. She also provides advice on philanthropic strategies to the firm's client service team and to clients directly. She is an attorney and CPA and has more than 25 years of finance-related experience, much of it in accounting.

Kristi has a bachelor's degree in business administration with an accounting concentration from the University of Washington and a Juris Doctor from the University of Washington School of Law. She is a member of the Washington State and King County Bar Associations, the CPA Society of Washington State and the American Institute of CPAs.

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