PERSPECTIVE

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Trump To The Internal Revenue Code: 'You're Fired!'

By Robert W. Wood

Donald Trump's surprise victory may have rattled the markets and triggered some protests. It is even fueling a "CalExit" movement, for the Golden State to go its own way. But it could invite some tax planning, too.

Candidate Trump made no secret of the fact that our tax system needs reform. In fact, he sought to blame the tax laws for making it possible for him to manipulate the tax law to pay so little. There was, after all, that controversial $916 million net operating loss. President-elect Trump might intend to tell the tax code, "you're fired!"

Of course, any change to the tax law is many months away, at the least. President-elect Trump does not take office until January, and can't do it alone. But it is also worth noting an extraordinary confluence of events that could mean big change in the tax law: The Republicans retained control over the House of Representatives and the Senate.

That means some tax cuts seem inevitable. This could suggest that deferring income into next year — if you can — might be wise. Under current law, we pay tax on ordinary income tax at graduated rates stretching from 10 percent to 39.6 percent. But since Obamacare, high-income taxpayers pay an additional 3.8 percent surtax on net investment income.

That means the top federal rate for individuals is really 43.4 percent. Qualified dividends and long-term capital gains are taxed at 15 percent or 20 percent, depending on your income. However, that rate too gets hit with the additional 3.8 percent for Obamacare's net investment income tax.

Trump has proposed cutting the tax brackets to three: 12 percent, 25 percent and 33 percent. He would eliminate the net investment income tax, too. As a result, the top rate would be 33 percent, with the top rate on capital gains and dividends a firm 20 percent. There are some drawbacks, though, that may alter your usual tax planning.

For example, Trump's tax plans call for slashing itemized deductions. Under Trump's plan, personal exemptions are eliminated. High earners already do not deduct personal exemptions due to the phase out, so this should have little impact. More consequential, though, is that itemized deductions would be capped at $200,000 for married couples.

The estate (or death) tax is another one Trump hates. Under current law, you can pass up to $5.45 million to your heirs tax-free. That is doubled for a married couple. But beyond this, you pay an estate tax of 40 percent. It is entirely separate from income taxes.

Hillary Clinton had proposed cutting the exemption materially from $5.45 million to $3.5 million. She also wanted to raise the estate tax rates to 50 percent and even 65 percent in some cases. The president-elect said he would repeal it entirely.

In California, where property values are high, it is not uncommon to end up with a taxable estate if you don't plan well. And family businesses can often face much bigger problems due to estate taxes. Trump's plan will therefore resonate with many.

Of course, if the estate tax is repealed, step-up in basis at death will go to. Under current law, you must consider income tax *and* estate tax. For income tax purposes, any appreciation inherent in your assets gets a stepped-up basis to the value on your date of death. That way you don't pay *both* income and estate tax on exactly the same dollars.

But if the estate tax is repealed, this feature of the income tax will go with it. According to Trump's proposal, the IRS income tax would capture the appreciation inherent in the assets of an estate valued in excess of $10 million. However, you would not pay on death. You would only pay this income tax when the beneficiary sells the assets.

Businesses are supposed to be in for big tax cuts. Corporations currently pay 35 percent. President-elect Trump would cut it to 15 percent. But he would eliminate most business deductions. And there would be simplicity.

Instead of depreciation over many years, he would allow up-front deductions. But forget deducting interest on debt, he has suggested. LLCs, partnerships and S corporations would have changes too. Candidate Trump suggested that the owners of these entities should pay the same 15 percent rate as corporations.

Astoundingly, that could mean someone taxed at 39.6 percent or even 43.4 percent on flow-through business income now, could see their tax rate slashed to 15 percent! Of all the proposed tax changes, this one — if it happens — may be the most momentous. Already, some people are wondering if they can cash in.

For example, can wage earners who are paying high income taxes now become independent contractors by forming an entity and conducting their own business? If you pay 39.6 percent now and could pay 15 percent by doing that, the incentives are huge. Of course, there are already huge fights and audits over worker status issues. And this change (if it happens) would most likely increase them.

Another change that could impact many international companies based in the U.S. would address the billions in overseas profits. These billions are currently escaping the U.S. tax system entirely. Trump's plan would impose up to a 10 percent deemed repatriation tax on the accumulated profits of foreign subsidiaries of U.S. companies.

That 10 percent toll charge would be payable over 10 years, Trump has proposed. Trump and his team say this change would trigger a huge inflow of funds back to the U.S. And for the future, Trump's proposals would tax future profits of foreign subsidiaries of U.S. companies each year as the profits are earned.

Much of the criticism of the Trump tax plans are that he would give the biggest breaks to the highest earners. Even so, supporters like to invoke the example of President Reagan. Trump and his team have suggested that this loosening up of capital at the top will encourage investment, trigger transactions, create jobs and fuel economic growth.

Change in the tax world is constant. And yet by any standards, some of the tax changes that seem likely in 2017 and beyond are going to be big. Huge.

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