With Republicans in control of the White House and both chambers of Congress, many think 2017 could be a major year for tax reform. It’s been three decades since the last major tax reform, but negotiation is in order before any type of reform will be accomplished.

President-elect Donald Trump and the Republican Party remain divided on a number of key policy questions. The tax proposals from Trump are not fully aligned with the current “Better Way for Tax Reform” proposals from the House Republicans. With two blueprints laid out for tax reform, we could see obstacles for getting any legislation passed.

This white paper takes a deeper look into the proposals of Trump versus the House GOP to illustrate what tax reform means in the eyes of the leaders.
### Income Tax Reform

In 1913, the 16th Amendment to the Constitution made the income tax a permanent fixture in the US tax system. The initial income tax rate started at 1% on the first $20,000, and rose as high as 7% on income over $500,000. In today’s dollars, that would be 1% on the first $463,000, and the 7% bracket would kick in at $11.5 million.

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### History of US Income Tax

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
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<tbody>
<tr>
<td>1913</td>
<td>16th Amendment made the income tax a permanent fixture in the US tax system.</td>
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<tr>
<td>1981</td>
<td>Congress enacted largest tax cut in US history, approximately $750 billion over 6 years.</td>
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<tr>
<td>1986</td>
<td>President Reagan signed into law the Tax Reform Act of 1986, one of the most significant reforms of the US tax code since the adoption of the income tax.</td>
</tr>
<tr>
<td>1990</td>
<td>Revenue Reconciliation Act was signed, providing a number of substantive provisions with an emphasis to increase taxes on the wealthy.</td>
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<tr>
<td>1993</td>
<td>Clinton signed the Revenue Reconciliation Act of 1993. The purpose was to reduce the federal deficit that would accumulate in fiscal years 1994–1998 by approximately $496 billion.</td>
</tr>
<tr>
<td>2001</td>
<td>George W. Bush signed a series of tax cuts, known as the Bush tax cuts.</td>
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</table>

As we look back at the history of income tax, we can see a steady pattern of growing complexity. While taxes have been certain, they’ve been far from consistent. A prominent desire for tax reform appears to occur once every generation. Considering the last major tax reform was 30 years ago it’s not entirely surprising that Congress is again looking at tax reform in 2017.

Despite the many changes to the tax code over time, many still believe our current tax system is overly complex. Simplifying the tax brackets is a common goal between Trump and the House GOP. Both proposals aim to consolidate the current seven tax brackets to three.
The highest bracket would cap off at 33%, down from our current 39.6%.

For married tax filers, the proposed income rates will be as follows:

- **$0–75,000 = 12%**
- **$75,001-225,000 = 25%**
- **$225,001+ = 33%**

*Brackets for single filers are ½ of these amounts*

### Single Tax Brackets

<table>
<thead>
<tr>
<th>CURRENT RATES</th>
<th>PROPOSED RATES</th>
<th>PROPOSED INCOME</th>
</tr>
</thead>
<tbody>
<tr>
<td>10% 15%</td>
<td>12%</td>
<td>$0–37,500</td>
</tr>
<tr>
<td>25% 28%</td>
<td>25%</td>
<td>$37,501–112,500</td>
</tr>
<tr>
<td>33% 35% 39.6%</td>
<td>33%</td>
<td>$112,501+</td>
</tr>
</tbody>
</table>

### Married Tax Brackets

<table>
<thead>
<tr>
<th>CURRENT RATES</th>
<th>PROPOSED RATES</th>
<th>PROPOSED INCOME</th>
</tr>
</thead>
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</tr>
<tr>
<td>33% 35% 39.6%</td>
<td>33%</td>
<td>$225,001+</td>
</tr>
</tbody>
</table>
Based on these proposed tax brackets, singles with taxable income between $127,500–200,500 would see a tax increase by 5%. On the contrary, taxpayers who currently expect to be in the 28%-33% tax bracket may save between 3-8% if the proposal were to pass.

**Deductions**

Tax deductions reduce your taxable income for the year and are commonly a result of expenses. Tax filers can either claim the standard deduction or they can itemize their deductions. Itemizing makes sense when your deductible expenses exceed the standard deduction.

In an effort to eliminate tax loopholes, Trump’s plan will cap itemized deductions at $100,000 for single filers and $200,000 for married filers.

The standard deduction will increase for joint filers to $30,000 from $12,600, and to $15,000 from $6,300 for single filers. The personal exemptions will be eliminated as will the head-of-household filing status.

Families supporting dependents would get new tax breaks under Trump’s plan. An above-the-line deduction for child care expenses would be available for up to four children. The deduction would only be available for kids under age 13, and would be capped at the average cost of child care in the state for a child of that age. In addition, the deduction would apply for both third-party child care facilities, and the implied average cost of child care would still be deductible if care is provided by stay-at-home parents or unpaid relatives serving as caretakers. The deduction would phase-out at income levels above $250,000 for individuals or $500,000 for married couples.

A similar above-the-line deduction would be available for eldercare expenses for a dependent parent living in the home. The eldercare expenses would cap off at $5,000 per year.

In addition, Trump has proposed a new Dependent Care Savings Account (DCSA). This account would be similar to a Health Savings Account with tax-deductible contributions up to $2,000 per year from all sources, and growth would be tax-free. There would be no “use it or lose it” requirements for a DCSA.

Contrarily, the House GOP plans to eliminate virtually all individual tax deductions except the mortgage and charitable deductions. The standard deduction would also increase under the GOP plan, but in this case the deduction would be less than what Trump is proposing. Individuals would be able to claim $12,000, an $18,000 deduction would be granted for individuals with a child and married couples would receive a $24,000 deduction.

The tax breaks Trump is proposing for families are not on the GOP proposal. Rather, their plan intends to consolidate the number of different types of retirement, college and other tax-preferenced accounts, as opposed to creating new ones.

<table>
<thead>
<tr>
<th></th>
<th>TRUMP</th>
<th>HOUSE GOP</th>
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<tbody>
<tr>
<td>Standard Deduction (Single)</td>
<td>$15,000</td>
<td>$12,000 ($18,000 w/ a child)</td>
</tr>
<tr>
<td>Standard Deduction (Married)</td>
<td>$30,000</td>
<td>$24,000</td>
</tr>
<tr>
<td>Itemized Deduction (Single)</td>
<td>$100,000</td>
<td>Eliminate all except mortgage interest and charitable contribution deduction</td>
</tr>
<tr>
<td>Itemized Deduction (Married)</td>
<td>$200,000</td>
<td></td>
</tr>
</tbody>
</table>
Recommendation: Maximize 2016 Deductions
If you’re a high-income earner who normally itemizes, you’ll want to claim as many deductions for 2016 when you’re likely to be in a higher tax bracket if legislation passes.

Exception
If you’re in the group of taxpayers who could be shifted into the 33% bracket from a lower bracket, you may want to delay those deductions until 2017.

Capital Gains Tax Rates
Capital gains tax rates depend on the amount of time a security is held. If an asset is held for a year or less before being sold it will be taxed at the short-term capital gains rate, which is currently taxed as ordinary income. If the security is held for longer than a year before being sold, it will be taxed at the long-term capital gains rate.

Trump and the House GOP are in disagreement when it comes to their proposals for long-term capital gains rates. Trump would like to keep the rates the same, but change the income thresholds to directly correspond with his three proposed tax brackets.

In contrast, the House GOP wants to cut the long-term capital gains rates entirely. Individuals would be allowed to exclude 50% of their investment income—including capital gains, qualified dividends and interest income—and then tax it at ordinary income rates. The 0% rate would become 6%; the 15% rate would separate into 12.5% and 16.5%; and the 20% rate would reduce to 16.5%.

<table>
<thead>
<tr>
<th>Capital Gains Rates: Single Filers</th>
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<tbody>
<tr>
<td><strong>CURRENT</strong></td>
</tr>
<tr>
<td>0% $0–37,650</td>
</tr>
<tr>
<td>15% $37,651–415,050*</td>
</tr>
<tr>
<td>20% $415,051+*</td>
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</tbody>
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<th>Capital Gains Rates: Married Filers</th>
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<tr>
<td><strong>CURRENT</strong></td>
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<tr>
<td>0% $0–75,300</td>
</tr>
<tr>
<td>15% $75,301–466,950*</td>
</tr>
<tr>
<td>20% $466,951+*</td>
</tr>
</tbody>
</table>

*Those earning more than $200,000 for single filers and more than $250,000 for joint filers may also have to pay a 3.8% Net Investment Income Tax.
Repeal Medicare Surtax

The Affordable Care Act of 2010 includes a provision of a 3.8% Net Investment Income Tax (Medicare surtax) to fund Medicare expansion. The tax, which came into effect in 2013, applies to certain unearned income including taxable interest, ordinary dividends and capital gains distributions.

Under Affordable Care Act, single taxpayers earning more than $200,000 and married taxpayers making more than $250,000 are subject to the 3.8% surtax. Trump and the GOP would both like to repeal the Medicare surtax entirely.

Repeal Alternative Minimum Tax (AMT)

The Alternative Minimum Tax was designed to keep wealthy taxpayers from using loopholes to avoid paying taxes. It started in 1969 when Congress noticed high-income earners were legally using so many deductions and other tax breaks that they were paying $0 in federal income taxes.

For many years the issue with AMT was that it was never indexed for inflation. Each year an increasing number of middle-income taxpayers were caught by a tax originally targeted at the rich.

The Tax Payer Relief Act of 2012 finally patched AMT for inflation. As inflation rises, the exemptions rise accordingly, thus eliminating more people from having to pay AMT.

Today, there is still scrutiny over the AMT. Many parties agree that the AMT needs to be changed, but some are against its outright repeal.

The AMT would be repealed under both Trump and House GOP tax plans.
Estate Tax Reform

Under current law (2016), estates larger than $5.45 million are subject to a 40% estate tax. Repealing the estate tax has been a longtime priority for the Republican Party and Trump stands behind it.

Less clear is what will happen to the gift tax, which applies to transfers during life, and to an income-tax provision known as the step-up. The step-up allows assets held at death to bypass capital gains tax. Heirs can “step up” the basis of an asset they receive to its fair market value on the day that the original owner died.

For example, under current law if you purchase a home for $300,000 and the property appreciates to $500,000 you would have to pay capital gains on $200,000 upon selling the property. Now if you were to pass away and leave the home for your children, they would receive what is called a step-up in basis. This means the cost-basis of the property would increase to the date of death value, $500,000. If the beneficiary of the property sells the home at the date of death value, he or she would not have to pay any capital gains tax. There would only be tax on every dollar the property appreciates over the new cost-basis, $500,000.

Trump plans to get rid of the step-up in basis for assets over $10 million if the estate tax is repealed. His plan has yet to mention whether the $10 million is for a married couple or individuals.
**Reduce Corporate Tax Rates**

Trump and the Republicans use supply-side reasoning when discussing tax cuts for businesses. They believe that greater tax cuts for entrepreneurs would provide incentives to save and invest, and produce economic benefits that would trickle down into the overall economy.

Trump’s proposal for corporate tax rates is to reduce rates from 35% to 15%. The rate would be available to all businesses, both small and large. Conversely, Republicans in Congress propose a 20% tax rate for corporations and a 25% rate on small business.

**Expense New Business Investments**

Currently, US businesses are generally not allowed to deduct the cost of their investments immediately. Instead they must spread out the deduction over long periods of time. The Tax Foundation estimates that moving to full expensing would increase long-run economic growth by 5.4%.\(^1\)

Both Trump and the House GOP would like to move to full expensing for businesses. Under the Trump proposal, companies engaged in manufacturing in the US may elect to immediately expense capital investments, but they lose the ability to deduct corporate interest expense.

The House GOP blueprint would also provide businesses with the benefit of immediately writing off the cost of investments, but under this blueprint, job creators will be allowed to deduct interest expense against any interest income. No current deduction will be allowed for net interest expense. Any net interest expense may be carried forward indefinitely and allowed as a deduction against net interest income in future years.

Most corporate tax expenditures would be revoked under both plans except for the research and development credit to encourage innovation.

**Repatriation of Corporate Earnings**

Currently, federal law allows corporations to defer paying taxes on their profit until they return it to the US, a process called repatriation. Fortune 500 firms may be avoiding around $695 billion in US income taxes on $2.4 trillion held offshore.\(^2\)

For the trillions in offshore profit that US companies have already accumulated, Trump suggests a one-time tax rate of 10%—a bargain that he says would lure that cash back to the US quickly and deliver economic growth as well as tax revenue for infrastructure spending.

The House GOP would like to move towards a destination-based tax system under which the taxing jurisdiction for business income would be based on the location of consumption. This would replace the current system of taxing US individuals on their worldwide income with a territorial tax system and it would provide for border adjustments exempting tax on exports and taxing imports.
**Individual Tax Strategies at Risk**

Look out for these tax-saving strategies that have been on the chopping block for the past several years.

**Backdoor Roth IRA**

A Roth IRA is an individual retirement account in which you only pay taxes on contributions and all future growth is tax-free. The backdoor Roth IRA strategy comes into play when someone is over the income limit threshold to contribute directly into a Roth IRA. Instead, high-income earners can take advantage of a ‘tax loophole’ by making an after-tax contribution directly into a traditional IRA and then converting it into a Roth.

To contribute directly to a Roth IRA, you must have compensation and your modified adjusted gross income (MAGI) must be less than $196,000 if you’re married filing jointly, and under $133,000 if you’re single. If you’re under 50 years old you can contribute up to $5,500, and if you’re over 50 the IRS gives you a $1,000 catch up.

Investors who don’t meet the limitations for contributing directly to a Roth IRA can look at doing a Roth conversion. There is no income cap for a Roth IRA conversion nor is there a contribution limit. However, if you have both pre-tax and after-tax money in a traditional IRA, the pro rata rule comes into effect.

<table>
<thead>
<tr>
<th>2017 Roth IRA Contribution Limits</th>
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<tbody>
<tr>
<td>Single</td>
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<tr>
<td>Married</td>
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</tbody>
</table>

**Pro Rata Rule**

The pro-rate rule is used to determine how much of a distribution is taxable when you have both after-tax and pre-tax dollars in your IRA. The rule states that, in general, an IRA distribution will consist of the same proportion of pre-tax and after-tax amounts as the IRA owner has in his or her IRAs. For the purpose of this rule, all traditional IRAs (including SEP and SIMPLE IRAS) are grouped as one giant IRA.

**Pro Rata Calculation**

In order to determine the percentage of each IRA distribution that is not taxable, first total after-tax dollars in all of your traditional IRAs and divide it by the 12/31 balance of all your IRAs combined. Next, multiply that percentage by the amount of all IRA distributions (remember all of your IRAs are grouped as one). The calculated amount represents the tax-free portion, and the remaining balance of the IRA distribution is taxable. Remember to include all distributions including conversions and any outstanding rollovers in that balance.
Example 1
Molly has a total of $100,000 in her IRAs. $5,000 out of the $100,000 is a post-tax contribution while the remaining $95,000 is pre-tax. Molly decides she wants to convert $5,000 to a Roth IRA. Upon converting the money, only 5% of the $5,000 would be tax-free.

Example 2
Richard has an IRA with a pre-tax balance of $5,000. Later, Rick decides to open another IRA and makes an after-tax contribution with an additional $5,000. When Rick decides to convert any of that money into a Roth IRA, 50% of it would be tax-free while the other 50% would be taxed upon the conversion.

Will the Backdoor Roth IRA Go Away?
We don’t know for sure, but it wouldn’t surprise us if the IRS tried to cut this tax haven to get more money in the hands of Uncle Sam. If a Roth conversion is beneficial for your situation, we recommend taking advantage of the strategy before it’s too late; however it’s important to consult a professional.

Net Unrealized Appreciation (NUA)
The NUA strategy benefits individuals who own appreciated employer stock in their 401(k). The assets inside your retirement plan are tax-deferred. Once you begin to take distributions from the account, you generally must pay ordinary income tax on the current market value of the asset distributed. If you use the NUA strategy, you could potentially distribute your company stock and pay taxes at a rate as low as 15%.

To take advantage of the NUA strategy, you simply request that the retirement plan distributes the shares of your employer stock to a taxable account at which time you pay ordinary income tax on the cost-basis of the stock. The cost-basis is the average of the individual values of employer stock when each portion was contributed to the plan or purchased. The difference between the cost basis and the market value at the time of distribution is the NUA. You are not required to pay tax on the NUA at the time of distribution, but you must pay tax on that amount when you sell the shares. At the time of sale, the NUA is taxed at the long-term capital gains rate even if the stock is held for one year or less after the time of distribution.

Since capital gains rates are currently less than most ordinary income rates, this strategy could serve as a huge tax saving for individuals that have appreciated company stock and are in a tax bracket higher than 15%. If you currently have company stock in your employer-sponsored plan we recommend reviewing this strategy with a professional before year-end to see if you can take advantage of the tax savings.
**Stretch IRA**

The stretch IRA is a financial strategy that has allowed people to stretch out the life, and therefore the tax advantages of an IRA after it’s inherited. Retirement account owners can name their children or grandchildren beneficiaries of their IRAs or Roth IRAs and these young heirs can stretch out the withdrawals over their own projected lifespan, enjoying decades of extra tax-deferred and/or tax-free growth.

Last year, President Obama’s budget proposal announced that putting a limit on stretch IRAs could potentially help raise a projected $4.6 billion over 10 years. On September 21, 2016 the Senate Committee on Finance voted 26-0 to effectively kill the stretch IRA.

The new rule, which has not yet officially passed, would require most retirement accounts inherited by anyone other than a spouse to be distributed (and in case of non-Roth accounts, taxed) within five years of the owner’s death. However, a $450,000 exclusion (indexed for inflation) was included in the provision. That is to say, $450,000 per IRA owner will still be eligible for the stretch IRA treatment that is consistent with today’s law.

Disabled heirs would still be able to stretch out withdrawals over their life spans and minor heirs wouldn’t have to distribute all the money until reaching age 26. As for spouses, they would continue to have great flexibility with a few various options. Some of which include:

- Rolling the account into their own name, postponing any withdrawals from a pre-tax account until they themselves turn 70½ or from a Roth account, until after their deaths.

- If the spouse is younger than of 59½ and will need to access the money, they might consider transferring the assets to an inherited IRA, allowing the spouse to access the money early without being subject to a 10% penalty.

**Conclusion**

Although tax reform appears to be a promising goal for 2017, it’s not a done deal. The proposals above are merely plans or suggestions put forward for consideration. Despite the high level similarities in both Trump and the House GOP plans, substantial differences still remain.

The House GOP tax reform aims to truly simplify the tax code down to the point that many individual tax returns could be filed on a postcard. On the other hand, Trump's proposals would ultimately maintain or even add to the complexity of the tax code. Agreement will need to be made before any legislation passes.

The Republicans may take over the House and Senate, but they fall short of the 60 votes required to avoid a filibuster. This gives the Democrats the power to severely limit what Republicans could accomplish in regards to tax reform.

**What does this mean for your tax planning?**

Although the US tax code faces several uncertainties, there are still several tax planning strategies that can come into play before year-end. Taxes are unavoidable, but paying too much in taxes can be avoided.
**Year-End Tax Planning Tips**

**Roth Conversions**

If you are in a low income year, we recommend looking at doing a Roth IRA conversion before year-end. When you convert money into a Roth IRA, you must pay tax on the conversion, but all future growth is tax-free. If contributing to a Roth IRA is beneficial for your situation, we recommend using a multi-year strategy. This allows you to have more control over your tax bracket now and in retirement when your required minimum distributions kick in.

There is no harm in doing a Roth conversion because you have the opportunity to change your mind later and undo it. Once you do a Roth conversion you have until you file your tax return the following year to decide whether you want to keep the conversion or ‘recharacterize’ it back into your IRA.

Reasons you may want to reverse a Roth IRA conversion:

- Value of your investments in the converted Roth IRA has declined.

- Your taxable income has ended up being higher than you expected and/or additional income from the Roth IRA conversion has bumped you into a higher federal income tax bracket.

- You don’t have enough cash on hand to pay the taxes.

**Tax-loss Harvesting**

If your capital gains are larger than your losses, you might want to do some “loss harvesting.” This means selling certain investments that will generate a loss to offset capital gains. The sold position is replaced with a position in the same asset class that has similar characteristics to maintain proper portfolio risk and expected returns. Through realizing the loss, you can offset the gain dollar for dollar.

You can use an unlimited amount of capital losses to offset capital gains. However, you are limited to only $3,000 of net capital losses that can offset other income, such as interest, dividends and wages. Any remaining unused capital losses can be carried forward into future years indefinitely.

Please note that if you sell an investment with a loss and then buy it right back, the IRS disallows the deduction. The “wash sale” rule says you must wait at least 30 days before buying back the same security to be able to claim the original loss as a deduction. However, you can buy a similar security to immediately replace the one you sold—perhaps a stock in the same sector. This strategy allows you to maintain your general market position while capitalizing a tax break.

If you think that you may have a heavy capital gains burden this year, talk to a tax expert and your financial professional about whether tax-loss harvesting may be a good strategy for you.
**Tax-gain Harvesting**

An opposite strategy to tax-loss harvesting is tax-gain harvesting. Instead of harvesting losses you harvest gains by selling investments that are up and buying them back immediately. The wash sale rule doesn’t apply to assets that have experienced a gain. This strategy allows you to get a step-up in basis, but should only be utilized if your current capital gains tax rate is lower than what you expect it will be in the future.

Remember that tax-gain harvesting does create income, potentially impacting certain deductions, tax credits and Social Security. Harvesting capital gains should be coordinated with other strategies.

**Donor Advised Fund**

Donor Advised Funds represent one of the fastest-growing charitable giving vehicles in the US, accounting for more than 3% of all charitable giving.\(^3\) It allows donors to make a charitable contribution, receive an immediate tax benefit and then recommend grants from the fund over time.

**How it works:**

1. You make an irrevocable contribution of personal assets.
2. You immediately receive the maximum tax deduction that the IRS allows.
3. You name your donor advised fund account, advisors and any successors or charitable beneficiaries.
4. Your contribution is placed into a fund where it can be invested and grow tax-free.
5. You can recommend grants from your account to qualified charities at any time after establishing your donor advised fund.

**Tax Benefits**

As soon as you make a donation, you are eligible for an immediate tax deduction, just as you would by donating to another public charity. Your tax deduction depends on the type of donation.

- **Cash donation:** If you donate cash, via check or wire transfer, you’re generally eligible for an income tax deduction of up to 50% of your adjusted gross income.

- **Long-term appreciated assets:** Donating long-term appreciated securities potentially allows you to maximize capital gains tax advantages, which could help you reduce taxes and ultimately give more to charity. If you have long-term appreciated assets, such as stocks, bonds or real estate, you have an opportunity to further maximize your deduction. By donating these types of assets directly to charity, you generally won’t have to pay capital gains, and you can take an income tax deduction in the amount of the full fair-market value, up to 30% of your adjusted gross income.
LOCATIONS

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Los Angeles  |  15233 Ventura Blvd., 5th Floor, Sherman Oaks, CA 91403
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Sources:

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