

Meridian Client Update

President Trump Proposal on Tax Reform

President Trump's proposed tax plan is largely similar to the plan outlined by the White House in July – large cut in corporate tax rate, reduction in individual tax rates with consolidation of tax brackets, elimination of most deductions and increase in the standard deduction.

Yesterday, the White House issued President Trump's proposal on tax reform entitled "Unified Framework for Fixing Our Broken Tax Code." The tax proposal provides slightly more details than the one issued in July, but remains a work in progress. The President has left it to the House Committee on Ways and Means and the Senate Finance Committee ("House and Senate Committees") to fill in the blanks.

Despite eager anticipation across Corporate America for the President's tax proposal, passage of something near to its current form remains uncertain.

Proposal on Corporate Income

The following are the key elements of the President's corporate tax proposal.

- **Substantial reduction in corporate tax rate.** The tax rate on corporate income would fall to 20% from 35%.
- **Elimination of the Corporate Alternative Minimum Tax (AMT).** Corporate AMT would be eliminated.
- **Acceleration of deduction for capital investments.** Businesses would be allowed to immediately deduct the cost of new investments in depreciable assets (other than structures) made after September 27, 2017, rather than amortize the cost over the assets' useful life. This accelerated deduction of capital investments would be available for at least five years.
- **Partial limitation on deduction for interest expense.** The deduction for net interest expense incurred by C corporations would be partially limited by a yet to be determined amount.
- **Treatment of other business deductions and credits.**
 - Elimination of domestic production ("section 199") deduction
 - Elimination or restriction of yet to be identified special exclusions, deductions and tax credits
 - Preservation of at least two tax incentives: (i) research and development (R&D) and (ii) low-income housing
- **Tax rules affecting specific industries.** Modernization of industry specific tax rules to ensure that the tax code better reflects economic reality and that such rules provide little opportunity for tax avoidance. The tax proposal provides no other details on this call for modernization of industry specific tax rules.

- **Move to territorial tax system.** Corporate earnings subject to tax would be limited to U.S.-derived income. Currently, a U.S. corporation's worldwide earnings are subject to taxation. The proposal would exempt from taxation dividends derived from foreign subsidiaries (in which the U.S. parent owns at least a 10% stake).
- **Treatment of accumulated foreign earnings.** The tax proposal would treat foreign earnings that have accumulated overseas under the prior tax code as repatriated and would subject these earnings to a yet to be determined reduced tax rate. The payment of this tax liability would be spread over several years.
- **Treatment of companies that ship jobs and capital overseas.** To prevent companies from shifting profits to tax havens, the tax proposal would tax at a reduced rate foreign profits of U.S. multinational corporations. The tax proposal directs the House and Senate Committees to draft rules to level the playing field between U.S.-headquartered parent companies and foreign-headquartered parent companies.

Meridian Comment. As we noted in our Client Update covering the White House July 2017 tax proposal, the proposed dramatic reduction in corporate tax rates and the move to a territorial tax system could profoundly affect companies' performance plans linked to net income, earnings per share or any other post-tax measure. According to a *Wall Street Journal* article, a Bank of America Merrill Lynch study concluded that S&P 500 companies would see a 12% increase in earnings per share **based on a 20% tax rate** and the U.S. moving to a territorial tax system.¹

We also observed in that Client Update that often performance awards expressly provide that the determination of achieved performance exclude the effect of substantial change in tax laws. Depending on the specific plan design, these awards would not be affected by enactment of President Trump's proposed tax plan. However, where a plan is silent, Boards and Compensation Committees will need to evaluate whether, and to what extent, any positive (and, in some cases, negative) effect of tax law changes on achieved performance should be considered. When companies develop incentive performance metrics for annual or long-term performance awards, they should address the potential tax impact on certain financial metrics, such as net income or earnings per share.

Proposal on Individual Income

The following are the key elements of the President's individual tax proposal.

- **Reduction in number of tax brackets and top marginal rate.** The number of tax brackets would fall to three from seven and the top marginal rate would fall to 35% from 39.6%. The three marginal rates would be 12%, 25% and 35%. However, the proposal does not identify income levels for each tax bracket. In addition, the tax proposal contemplates the possibility of adding a new higher tax bracket "to ensure that the reformed tax code is at least as progressive as the existing tax code and does not shift the tax burden from high-income to lower- and middle-income taxpayers."
- **Elimination of most itemized deductions.** The tax proposal would retain deductions for mortgage interest and charitable contributions and would eliminate all other itemized deductions (e.g., real estate taxes paid, State and local taxes paid, casualty and theft losses).
- **Increased standard deduction.** The standard deduction for a married couple filing jointly would almost double to \$24,000 from \$12,700. For a single taxpayer, the standard deduction would be \$12,000. The proposal would eliminated personal exemptions.

¹ Francis, Theo and Rubin, Richard, *Companies Dig Into Details of Proposal*, Wall Street Journal, April 27, 2017, p.A4.

- **Elimination of alternative minimum tax (AMT).** AMT would be repealed.
- **Elimination of other exemptions, deductions and credits.** Other yet to be identified exemptions, deductions and credits for individuals that “riddle the tax code” would be repealed.
- **Elimination of estate tax and generation-skipping transfer tax.** The estate tax and generation-skipping transfer tax would be repealed.
- **Enhancement to Child Tax Credit and Middle Class Tax Relief.** The tax proposal would broaden the availability of the Child Tax Credit by increasing the income levels at which the Child Tax Credit begins to phase out. The proposal does not specify the increased income levels. The proposal would also provide a non-refundable credit of \$500 for non-child dependents to help defray the cost of caring for other dependents. The tax proposal directs the House and Senate Committees to work on additional measures to reduce the tax burden on the middle-class.
- **Introduction of new special tax on pass-through business income.** Currently, income from pass-through entities (e.g., partnership income, Sub S income) is treated like wages for tax purposes. That is, such income is subject to the same marginal tax rates applicable to W-2 wages. Under the tax proposal, a special 25% flat tax would apply to “business income” derived from a pass-through entity. The House and Senate Committees are directed to write rules to prevent the characterization of personal income into business income to prevent wealthy individuals from avoiding the top personal tax rate.
- **Retention of tax benefits related to work, education and retirement.** The tax proposal would retain tax benefits (which are not identified) that encourage work, higher education and retirement security. The tax proposal encourages the House and Senate Committees to simplify these benefits to improve their efficiency and effectiveness.

Unlike the President’s July 2017 tax proposal, the current proposal does not include proposed changes to capital gain tax or tax on dividends.

Meridian Comment. The proposed 25% tax rate on pass-through business income (and on income derived by sole proprietorships) appears to be among the more controversial and complex aspects of the President’s tax proposal. The tax proposal directs the House and Senate Committees to write rules to distinguish between personal compensation income and business income earned under a pass-through entity. The former would be subject to the progressive tax rates while the latter would be subject to the flat 25% tax rate.

The next two pages show side-by-side comparisons of the Trump administration tax proposal against current tax law.

Comparison of Corporate Tax Proposal Against Current Tax Law

Tax Provision	Current Tax Rates/Policy	Trump Tax Proposal
Corporate Tax Rate	35.0%	20.0%
Income Subject To Tax	Worldwide Income	U.S. Income
Alternative Minimum Tax	20.0%	Repeal
Deduction for Capital Expenditures	Ratably over useful life	Immediate, (available over the next five years)
Interest Expense	Fully Deductible	Partially Deductible
Domestic Production Deduction (section 199)	Based on a % of qualifying domestic production gross receipts	Repeal
Other Deductions and Tax Credits	Various	Repeal/modify, to be determined
Research and Development Credit	Based on a % of qualified R&D expense	Preserves
Industry-Related Tax Rules	Various	To be determined
Taxable Income	Worldwide Income	U.S. Income
Accumulated Foreign Earnings	Subject to U.S. corporate tax when repatriated	Accumulated foreign earnings under prior tax law is treated as repatriated and subject to a reduced tax rate
Treatment of companies that shift jobs and capital overseas	No policy	Subject foreign earnings of U.S. multinational corporations to a reduced tax rate

Comparison of Individual Tax Proposal Against Current Tax Law

Tax Provision			Current 2017 Tax Rates/Policy	Trump Tax Proposal
Income Tax Brackets (Married Filing Jointly)				12.0%*
\$0	to	\$18,650	10.0%	
\$18,651	to	\$75,900	15.0%	25.0%*
\$75,901	to	\$153,100	25.0%	35.0%*
\$153,101	to	\$233,350	28.0%	
\$233,351	to	\$416,700	33.0%	
\$416,701	to	\$470,700	35.0%	
\$470,701			39.6%	
Standard Deduction (married filing jointly)			\$12,700	\$24,000
Personal Exemption			\$4,050 per exemption, subject to income-based phase out	Repeals
Child Tax Credit			Up to \$1,000 for each qualifying child, subject to income-based phase out	Increases income levels at which the Child Tax Credit is phased out (income levels not specified) Adds non-refundable credit of \$500 for non-child dependents to help defray the cost of caring for other dependents
Certain Pass-Through Income			Added to other taxable income, which is subject to above rates	25%**
Itemized Deductions			6 categories *State & Local Taxes *Medical & Dental *Mortgage Interest *Charitable Contributions *Casualty & Theft Losses *Job Expenses & Certain Misc. Expenses	2 categories *Mortgage Interest *Charitable Contributions
Other Exemptions, Deductions and Credits			Various	Repeals other yet to be identified exemptions, deductions and credits
Work, Education and Retirement			Various	Retains tax benefits (which are not identified) that encourage work, higher education and retirement security. House and Senate Committees to simplify these benefits to improve their efficiency and effectiveness.
Alternative Minimum Tax			28.0%	Repeals
Estate Tax and Generation Skipping Tax			40.0%	Repeals

*The tax proposal does not specify income levels for each tax bracket.

**The tax proposal would limit availability of the special flat rate to high-income tax payers.

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