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## Tax reform framework reflects multiple moving pieces

By Michael Cohn

The tax reform framework released last month by the Trump administration and Republican leaders in Congress could provide tax cuts or tax increases, depending on how the details are ultimately finalized.

“There’s a lot of moving pieces in this,” said Manuel E. Pravia, a principal in the Tax and Accounting Department at the accounting firm MBAF's Miami office. “I think there are a lot of good things overall, but there are some things where additional detail is needed.”

Accounting firms might not be the beneficiaries of the tax reform framework, even though their clients will need lots of extra help coping with the proposed changes. Treasury Secretary Steven Mnuchin has even said the lower tax rate might not apply to accounting firms (see Mnuchin proposes not cutting taxes for accounting firms).

Pravia pointed to the 25 percent rate for pass-through businesses. “It’s a lower rate than what would be the higher proposed rate of 35 percent,” he said. “But to what does it apply? If you dig down a little bit, it would not apply to service-oriented businesses like accountants, lawyers, people who do consulting. They are excluded from that lower rate and presumably that income would be taxed still at the higher rate, but we don’t know where it starts. So part of the difficulty in implementing that might be for something that is not as cut and dried. You say ‘service’ and what do you think of? CPAs, lawyers, doctors. But what about a carpenter or an interior designer? Is it a service, or am I selling you goods? There might be some gray areas that either need to be clarified now, or down the road are subject to potential higher IRS pushback. It’s still the Internal Revenue Service, emphasis on revenue.”

Others might even see tax hikes unless they are offset somehow. “There’s a lot of other things that at first glance might be seem bad, like the lower tax rate going up marginally from 10 percent to 12 percent,” said Pravia. “However, you would think that’s offset by the higher zero tax bracket that is created by the standard deduction. Not knowing where the cutoffs are, going from five brackets to three, while it does simplify it, there could be some bracket leakage in terms of do you fall up or do you fall down? Is it a tax cut or a tax increase for particular people?”

Nevertheless, he is glad to see the tax framework getting rid of the alternative minimum tax and the estate tax.

“The alternative minimum tax being gone—good riddance,” he said. “Nobody is going to shed a single tear over that one. The estate tax being gone certainly helps our high net worth clients a lot. A lot of time and effort has been spent in the past with estate planning.”

Corporate tax reform could be good or bad, depending on how it’s going to happen and whether it will really encourage companies to repatriate their foreign profits.

"If I'm only going to tax you on that 20 percent and I'm not going to tax you on your foreign earnings, you've all of a sudden turned it into a strictly territorial tax," said Pravia. "There's that one-time toll that they're proposing, 10 percent on the $2 trillion out there waiting to be repatriated. Well, what's the complexity there? When are you going to pay that? How are you going to pay that? What if it's sitting in something that's not necessarily liquid because of investing, whether it's plant, equipment, whatever it might be? How is that going to work out? But it certainly does simplify that. Many of the complexities relating to the foreign tax regime and the related repatriation would go away forever."

However, he cautioned that companies could see an impact on their financial statements if they have been deferring taxes on their foreign profits.

"It's worth mentioning the enactment of the lower tax rate will have a financial statement impact to the various companies that are carrying deferred tax assets and liabilities at 35-plus percent," said Pravia. "Remember, the state income tax affected that, but ignoring that and taking just federal, when you lower the top rate from 35 to 20 percent, if you have a deferred tax liability on your books, you get a windfall. You get actual earnings that go to your P&L and more earnings per share. Of course, you know what the flip side is. If you have a deferred tax asset, a future benefit, you have taken a haircut to that benefit and your earnings will take a one-time hit and impact. What would that do to stock prices, and to the market overall?"

The stock market may have been pricing in some of the potential impact already. "It won't all come at once," said Pravia. "Upon enactment, there will be a flurry and wave of either upside or downside earnings."

He noted that some public companies have already talked about the potential impact of tax reform in the management discussion and analysis section of their annual reports. The impact could be big for companies in industries where deferred tax assets might be part of their regulatory capital. "Banking comes to mind, insurance," said Pravia. "That has its own set of complexities there too if all of a sudden you lose some of your capital that you were counting on to meet regulatory ratios and be well capitalized."

Pass-through businesses will also get some tax breaks, although Congress will need to be careful to keep people from claiming to be businesses just to claim a lower tax rate.

"Behind all these pass-through entities there are usually individual taxpayers, so a lot of them are set up for legal reasons, and the pass-throughs particularly for service companies," said Pravia. "My salary for my personal service corporation, for my S corporation, would be taxed at ordinary rates, presumably the highest bracket now, 35 percent. But I can't just pay myself a salary of $5,000 because that's not reasonable, and then there's an unfair tax rate arbitrage the IRS would say, and rightfully so. You do see those cases now, just for the element of the payroll taxes and the Social Security, but it would become even more of an issue if enacted."

Congress will try to stimulate small businesses such as manufacturers, but it may not give the same tax breaks to service businesses.

“There have been some provisions in recent years, whether it’s Section 179 or the soon to be phased out bonus depreciation, that already do some of that to a certain extent,” said Pravia.

To pay for reduced tax rates, the tax reform framework limits many types of itemized deductions. “We are talking a lot about giving, but what am I going to take away to pay for that? And that’s where you get into some of the itemized deductions that are not going to be around anymore,” said Pravia. “For real estate taxes and state income taxes, many people around the country will not be happy. The medical expense deduction would be going away. Everybody talks about the high cost of health care. Taking away some of the itemized deductions for that, even though you already had a floor that has to exceed 10 percent, doesn’t do anything to make it more palatable. But there are going to be winners and losers, and in the end there are going to have be a lot of losers to offset a lot of winners.”

While the tax deductions for charitable contributions and home mortgage interest specifically will survive under the framework, many other tax deductions could be disappearing. Many taxpayers would be affected by the disappearance of the personal exemption under the proposal, and their taxes might not be offset by the proposed doubling of the standard deduction and expansion of the child tax credit.

“The more kids that you have, you could be hurt by losing some of the personal exemptions because it’s just a doubling of the standard deduction, and no additional personal exemptions,” said Pravia. “So although there’s supposed to be an ‘enhanced’ child tax credit if you have an extra kid or two, somewhere in here there’s going to be winners and losers. The way it’s being pitched to the average American middle-class it’s supposed to be a tax cut, although on the face of it the bottom rate going from 10 to 12 percent makes it seem like it’s not.”