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Client Alert

Current Issues Relevant to Our Clients

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The Future of Individual Income Tax?

The Tax Reform Act of 2014 (the "Proposal") intends to simplify and consolidate the individual taxation scheme by consolidating, changing, or eliminating a variety of current tax benefits and the tax rates. The following is a summary of a number of the most significant provisions of the Proposal for individual taxpayers. We have also prepared summaries of other provisions relevant to other areas of the Internal Revenue Code, which are available on our website. Although the Proposal has not yet been formally introduced as a bill and it's future is uncertain, it represents a significant statement regarding tax policy and we will monitor its progress.

Tax Rate Changes

The Proposal consolidates the current seven individual tax brackets into just three brackets. The chart below illustrates the changes for a joint filer. For estates and trusts, the tax rate is a single 35% rate for income over $12,000. The Proposal also eliminates the preferential tax rates for long-term capital gains and qualified dividends, but provides an above-the-line deduction of 40% of adjusted net capital gain (*i.e.*, 40% of net capital gain and qualified dividends would not be subject to tax). Qualified domestic manufacturing income (defined as the net income attributable to domestic manufacturing gross receipts) would also receive favorable treatment, being taxed at rates no higher than 25%.

2014 Tax Brackets	Current Tax Rate	Proposed Rate
$0 – $18,150	10%	10%
$18,151 – $73,800	15%	
$73,801 – $148,850	25%	25%*
$148,851 – $226,850	28%	
$226,851 – $405,100	33%	
$405,101 – $457,600	35%	
$457,601+	39.6%	35%

For high-income taxpayers ($250,000 for single filers or $300,000 for joint filers), the Proposal would phase out the tax benefit of the 10% bracket (*i.e.* would phase in a 25% tax rate rather than a 10% rate).

Personal Exemptions and Credits

The Proposal eliminates all current personal exemptions, replacing these amounts with a single, much larger standard deduction and an expanded child and dependent tax credit. The chart below illustrates the changes.

	Current Standard Deduction and Personal Exemptions (2014)	Proposal Standard Deduction
Joint filer	$12,400 plus $3,950 for each of taxpayer, spouse, and qualifying dependent (phased out for AGI over $305,050)	$22,000 (phased out for MAGI over $517,500)
Head of household	$9,100 plus $3,950 for taxpayer and each qualifying dependent (phased out for AGI over $279,650)	$11,000 (phased out for MAGI over $358,750) plus $5,500 with qualifying child (phased out for AGI over $30,000)
Single filer	$6,200 plus $3,950 for taxpayer and each qualifying dependent (phased out for AGI over $254,200)	

* The 25% rate would actually begin at $72,500.

	Current Credits	Proposal Credits
Child tax credit	$1,000 per child (subject to phase out at $75,000 for single filers and $110,000 for joint filers)	$1,500 per child (subject to phase out at $413,750 for single filers and $627,500 for joint filers)
Non-child dependent credit	None	$500 subject to phase-out

The earned income tax credit for certain low-income workers would be replaced with a payroll tax credit or rebate, ranging from $100 (for single taxpayers without a qualifying child) to $4,000 (for joint filers with more than one qualifying child).

Education Credits and Deductions

The Proposal eliminates a number of education related deductions, exclusions, and credits, including the deduction for interest on educational loans, deduction for qualified tuition expenses, Hope credit, and the exclusions for discharge of student loan indebtedness, for employer education assistance programs and for interest on US savings bonds used to pay qualified higher education expenses. The Proposal provides a single tax credit for tuition and expenses. A 100% tax credit would be available for the first $2,000 of higher education expenses, and a 25% credit would be available for the next $2,000. The credit would be phased out for taxpayers with MAGI between $86,000 and $126,000 for joint filers and between $43,000 and $63,000 for other filers.

Deductions and Credits Eliminated

The Proposal maintains the charitable deduction and the mortgage interest deduction, with a few changes (as discussed below), but eliminates many other itemized deductions (*i.e.*, Schedule A deductions). The Proposal also eliminates many above-the-line deductions and tax credits:

Above-the-Line Deductions Eliminated	Itemized Deductions Eliminated	Tax Credits Eliminated
▪ employee moving expenses ▪ contributions to Archer medical savings accounts ▪ alimony payments*	▪ medical expenses ▪ state income and property taxes ▪ unreimbursed employee expenses ▪ personal casualty losses ▪ tax preparation fee	▪ dependent care credit ▪ adoption expenses ▪ energy-efficient residences ▪ electric and other alternative motor vehicles ▪ health insurance costs ▪ first-time homebuyer

Other Modifications to Exclusions, Deductions and Credits

Although the Proposal eliminates many itemized deductions, the proposal would also eliminate the 2% floor on miscellaneous itemized deductions (such as investment expenses) and eliminate the current itemized deduction limitation rule for taxpayers over certain income thresholds.

A number of the deductions, credits, and income exclusions that would still be available would nevertheless be eliminated for taxpayers in the new 35% tax bracket: the standard deduction; all itemized deductions except the deduction for charitable contributions; the foreign earned income exclusion (including the exclusions for income from Puerto Rico and U.S. possessions); tax-exempt interest; employer contributions to health, accident, and defined contribution retirement plans to the extent excluded from gross income; the deduction for health insurance premiums for self-employed; the deduction for contributions to Health Savings Accounts; and the portion of Social Security benefits excluded from gross income.

The Proposal would modify the $500,000 gain exclusion on the sale of a principal residence ($250,000 for single filers) by increasing the holding period to 5 of the prior 8 years (rather than 2 of 5 years) and permit use of the exclusion once every 5 years (instead of every 2 years). This exclusion would be phased out for MAGI over $500,000 for joint filers ($250,000 for single filers).

* For divorce decrees after 2014. Concurrently, the receipt of alimony payments would *not* be taxable income to the payee.

Although the Proposal maintains the deduction for mortgage interest, it would be limited to interest on qualified mortgage debt up to $500,000, reduced from the current $1,000,000, with the reduction introduced over the next 4 years, for debt after 2014.

The Proposal provides some additional charitable contribution rules. The Proposal would permit charitable contribution made prior to April 15 to be deducted on the prior year's return. The Proposal would modify the current limitations on charitable contributions (which are 50%, 30%, or 20% of AGI, depending on the type of contribution and type of charitable organization) to a single 40% of AGI limitation on all gifts of cash or property to a public charity or operating private foundation and a 25% of AGI limitation on all gifts to a private foundation. The Proposal would limit the value of non-cash gifts to charity to the lesser of fair market value or taxpayer's cost basis, subject to some exceptions, including for gifts of publicly traded stock and property that is related to the exempt purpose of the organization.

Contributions to and Distributions from Retirement Plans

The Proposal would freeze the current contribution limits for retirement plans until 2024.

The Proposal also seeks to promote Roth IRAs and Roth contributions to employer plans by (1) prohibiting additional contributions to traditional IRAs, (2) eliminating the income eligibility limits for contributions to Roth IRAs, and (3) limiting the amount of non-Roth, or traditional, contributions to 401(k), 403(b) and 457(b) plans to the first half of the contribution limit (which would be $8,750 currently), with all additional contributions required to be Roth contributions.

Because no additional contributions are permitted to traditional Roth IRAs, if a taxpayer converts a traditional IRA to a Roth IRA, the taxpayer may not re-characterize the conversion back to a traditional IRA.

The Proposal also largely eliminates the stretch-out of qualified retirement plans and IRAs after the death of the employee or owner. Under the proposal, the retirement plan or IRA must be distributed within 5 years of the employee's or owner's death unless the beneficiary is a spouse, a child under age 22, or an individual who is either disabled, chronically ill or not more than 10 years younger (referred to as the "eligible designated beneficiaries"). If an eligible designated beneficiary subsequently dies or ceases to be eligible (*i.e.*, the child attains age 22 or the disabled or chronically ill designation changes), then distribution must be made over the next 5 years.

The Proposal makes a number of changes to retirement plan rules. The above summarizes the changes that impact individual contributions to and distributions from qualified retirement plans. A separate alert on employee benefits and retirement plans will address the Proposal changes in those area in more detail.

To the extent that any part of this summary is interpreted as being tax advice, (i) no taxpayer may rely upon this summary for the purposes of avoiding penalties, (ii) this summary may be interpreted for tax purposes as being prepared in connection with the promotion of the transactions described, and (iii) taxpayers should consult independent tax advisors.

For More Information

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