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A Tough Tax Act to Follow

A Piecemeal Approach to Reform That Will Need Its Own Reform

An article by David Lifson

In order to meet legislative rules that would have required some bipartisan support, the Republicans have passed historic and comprehensive tax reform legislation that is already in need of comprehensive reform.

This version of the Internal Revenue Code (IRC) will almost certainly not last long; it is designed to be modified before it reverts to the old law with respect to most of its provisions for individuals and estates. Other provisions are experiments that may be heavily burdened with administrative complexity; reading the 1,000-page law and explanation is a little like a treasure hunt that sometimes unearths items better left buried.

Popularly known as the *Tax Cuts and Jobs Act of 2017* (TCJA), the new law takes a piecemeal approach to tax reform. Due to political needs, it cuts taxes or provides enhanced benefits for individuals who pay very little income tax, particularly as a percentage of their overall tax burden; this was difficult to do in absolute dollar terms. It also proposes to create jobs through business incentives, sometimes in a novel way. Other taxes have been lost in the debate, but should not be ignored. On the whole, it is incredibly difficult to generalize about how to cope with the new rules for the upper-income individuals, families, and businesses that pay most of the federal income tax.

On one end of the tax spectrum, things are much simpler for a majority of the U.S. population. These taxpayers, typically with family incomes under $75,000 and who are often referred to as low- or middle-income taxpayers, pay their federal taxes through single-rate payroll taxes (or self-employment taxes). They also pay state tax on income and on consumption through sales and property taxes. A March 2015 report by the Joint Committee on Taxation indicated that 80 million tax filers reporting income of $40,000 or less collectively paid no federal income tax, with some of them receiving cash payments for the Earned Income and Child Tax Credits. This same group paid (directly or indirectly) $121 billion in Social Security and Medicare taxes, of which about half was paid by employers and half was paid by workers. Cutting their federal income tax, which is only a small part of their overall tax burden, would at best have a subdued effect on their disposable income. The same report shows that a typical family's income must exceed six figures before its federal income taxes are larger than its federal payroll taxes. State income taxes also play a significant role in measuring family tax burden.

While the TCJA will produce winners and losers, the popular press overgeneralizes their profile. Where one lives, how one earns, when one pays, which tax elections one makes, and even when one dies become important factors in measuring the winners and losers. The law's piecemeal approach creates higher taxes for some and lower taxes for others, and the results will change year-to-year and taxpayer-to-taxpayer. The following is a summary of some of the more significant provisions in the new law, with some speculation on their implications.

Where Are We Now?

Everyone is asking: "Will my taxes go up, or will my taxes go down?" Generalizations are difficult, and the answer must be: "It depends." As a result, the value of a custom-tailored tax plan for high-income taxpayers will increase. Low-income households will also need help in maximizing the benefits available to them. Taxpayers in the middle will have a difficult time determining where they fit in the new federal tax schema, particularly because many of the new tax benefits have been designed to favor how a business is structured.

Choice of Entity

Structure will be a recurring theme for 2018. Previously, industries or activities were encouraged through so-called tax expenditures (for example, oil and gas through the depletion allowance, energy through various tax credits and research and development). Much of the conversation now will focus on how a taxpayer earns income: as a C corporation, as a pass-through (S corporation, partnership/LLC, trust, or proprietorship), or through wages. Armed with 2017 results and actual tax data, tax advisers should focus on pro forma 2018 results and consider the opportunities.

Changes in the tax law enacted by the *Tax Reform Act of 1986* (TRA '86), combined with the willingness of states to create limited liability companies, brought about a substantial change in the way American businesses operate. Prior to 1986, a startup business could grow and eventually be sold without incurring double taxation – a tax at the corporate level when the business is sold and at the owner level when sales proceeds are received. The single tax was based on a judicial precedent called the *General Utilities* doctrine, overturned by TRA '86, which mandated a tax on profits at the corporate level from both operations and a subsequent sale and liquidation. In addition, by the 1980s, the large disparity between high individual tax rates and low corporate tax rates had narrowed, and employment and pension benefits had largely been equalized for all businesses, so the advantage of operating in corporate form at a lower annual tax cost had largely evaporated. For most businesses other than public companies and those seeking institutional financing, the flow-through structure produced the lowest overall tax to the owners and was the most operationally efficient.

When Congress found it necessary to lower corporate rates and create a territorial tax system for corporate taxpayers to increase global competitiveness, the higher individual tax rate applicable to flow-through businesses became politically unpalatable, even though most everyone had the option of converting to a corporation tax-free. The political solution born in the Senate was to design a deduction for "qualified business income" through the introduction of IRC Section 199A. Qualified business income enjoys a lower tax rate and includes profits from a partnership, an S-corp, or a sole proprietorship, as well as income from certain specialized investment vehicles and entities such as real estate investment trusts (REITs), specified cooperatives, and some publicly traded partnerships.

As a result, Congress was able to boast that, in addition to reducing the corporate tax rate to 21 percent, the pass-through tax rate for qualified businesses was effectively reduced from 39.6 percent (the old maximum rate for high-income individuals) to 29.6 percent, far less than the new 37 percent top bracket for individuals. This lower pass-through rate is limited, however, and not always available.

Deduction for Qualified Business Income

The general rule provides a 20 percent deduction for qualified business income – but not all pass-through income is qualified, and there are limitations and key exceptions designed to lower the cost of the TCJA and defer or phase out the benefit.

Qualified business income only includes domestic business income; it excludes investment income, including interest, capital gains, and foreign currency gains. The business normally must employ workers or capital to qualify for the deduction, as it is further limited based on a wage threshold or a return-on-investment threshold for high-income taxpayers; the income subject to the 20 percent deduction cannot exceed 50 percent of the taxpayer's pro rata share of W-2 wages paid by the business or the sum of 25 percent of the W-2 wages plus a 2.5 percent return on qualified property. Qualified property includes the original cost (before depreciation) of all business property

(other than land) in use at the end of the year, even if it is fully depreciated, as long as it is in service at each successive year-end for the longer of 10 years or its normal depreciation life. A fully depreciated machine with a normal 5-year life put in service on Dec. 1, 2009, can be qualified property through the December 2018 year-end, while the building it occupies with a 39-year life opened the same day is qualified until 2047.

This adjustment does not change a taxpayer's adjusted gross income (AGI); instead, it is a deduction from AGI to calculate taxable income that is available to individuals regardless of whether they claim standard or itemized deductions. This also maintains most state and local tax bases, since most rely on AGI as a starting point. Only Colorado, Idaho, North Dakota, Oregon, South Carolina, and Vermont currently rely on federal taxable income for their tax base.

In order to concentrate the benefit on real estate and manufacturing businesses, the deduction is phased out for those in "specified service businesses." Last-minute changes retained the deduction for architects and engineers, but the list of excluded activities subject to the income limitation is long. Specified service businesses include consultants; healthcare professionals; lawyers; athletes; financial service professionals (including accountants); brokers; investing and investment management services; trading or dealing in securities, partnership interests, or commodities; and a catchall that includes, according to the conference report, "any trade or business where the principal asset of such trade or business is the reputation or skill of one or more employees or owners." What remains unclear is how aggregation rules (or disaggregation rules for investors promoting skilled individuals) will integrate the passive activity loss rules with the new 20 percent deduction for qualified business income. It is likely there will be significant conversation in the tax community about these matters in the coming months.

Lower-income taxpayers may use the 20 percent deduction with a phaseout based on taxable income of both spouses in a joint tax return, even when the other spouse has no connection to the business. The qualified business income phases out for single filers with incomes above $157,500 and joint filers at $315,000, and is eliminated at $207,500 for single filers and $415,000 for joint filers. For example, an accountant's daughter and business partner planning her wedding for sometime after her fiancé's December graduation as a full-time graduate student could decide to get married on New Year's Eve, rather than waiting until June, to help finance the wedding with the tax savings from the extra $31,500 (20 percent of $157,500) tax deduction available in a joint tax return.

New Annual Loss and NOL Limitations

Congress has included a new limitation on the deduction of losses from all trade or business activities, including passive activities. Taxpayers other than corporations were previously allowed an unlimited deduction for these losses, including suspended losses upon the termination of an activity. The new limitation only permits an annual deduction of $500,000 for joint filers and $250,000 for all others, with any excess only available as a net operating loss (NOL) deduction. Separately, corporate and individual NOL deductions will no longer be carried back, and those that can be carried forward arising annually after 2017 are limited to 80 percent of the loss in later years. Exceptions apply to farming and insurance companies.

SALT

SALT has been an insiders' abbreviation for state and local tax for decades. It is now in the everyday lexicon due to the elimination of the tax deduction for most individuals' personal state and local taxes, either through the new $10,000 per year limitation for these costs in the case of middle- and upper-income taxpayers, or through the expansion of the standard deduction that eliminates the need to itemize for lower-income families. In fact, the proposed elimination of this deduction almost derailed TRA '86 until a compromise was reached. This time, objections from high-tax states did not prevail.

This base broadening dramatically increases the tax rate on high-income taxpayers living in high-tax states such as New York, New Jersey, California, Hawaii, and Oregon. The effective incremental income tax rate (including the Additional Medicare tax) for a high-income New York City tax resident solely with wage income will increase from 49.5 percent to 52 percent; an investor with only long-term capital gains and qualified dividend income will see virtually no change and continue to be taxed at just over

36 percent. The effective rate is a bit more for a California resident and a bit less for a New Jersey resident; the rate for each individual taxpayer depends upon their personal profile. The change in tax rate for a resident of a low-tax state with no income tax, such as Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming, is likely to be small and based solely on property and sales tax limitations.

The loss of the SALT deduction only relates to personal income taxes, not business income taxes. Real estate and personal property tax on a business's assets, as well as business-level income taxes – such as Philadelphia's Business Privilege Tax and New York City's Unincorporated Business Tax (UBT) – that are traditionally deducted "above the line" to arrive at AGI, remain deductible. State corporate income taxes are also deductible.

The loss of the deduction for residents in states like New York and California has created significant resentment; it may be up to each state legislature to find a solution. Perhaps the law could change to tax either business self-employment income or the business profits instead of the individual at the state level, creating a trade or business expense deduction. For example, New York State could expand its UBT statewide to provide a business-level tax for all non-corporate business; the income subject to the UBT could be excluded from the personal income tax base for both residents and nonresidents. The tax rates could be coordinated with New York City's UBT (and set at a higher level for NYC businesses to replace the current city-only UBT) and set at an appropriate level to replace the revenue lost from the state personal income tax exclusion.

Collection of a business-level tax in lieu of an individual income tax would conform to the new federal audit regime for partnerships. It should be easier to administer in the long run, particularly with respect to nonresident individuals. It would certainly reduce the shock of the lost tax deduction for business decision-makers who are likely to consider alternate locations in light of the new federal tax structure. This legislative change would also put New York businesses on par with corporations that still enjoy the tax deduction for the privilege of doing business in New York State and put New York residents on par with low-tax states. Is it politically feasible? Only time will tell.

International

Taxation of the nearly $3 trillion of untaxed overseas profits of foreign businesses owned by U.S. persons was inevitable and has been proposed for more than a decade. The United States' ability to sustain its taxation of global profits has been under attack ever since most other nations moved to territorial tax systems that allow their multinational companies to exploit foreign markets with little or no home country tax.

The ability to defer the tax on foreign income and the debate over whether it should be taxed at all traces back to the Kennedy administration and key decisions made in 1969 by the Nixon administration. The world has changed a lot since then. Corporations are far more mobile than people; they can be managed from anywhere. Trapping U.S.-incorporated businesses with anti-inversion regulations became challenging, and some experts expressed a concern for the life of the U.S.-incorporated multinational under a global

tax burden. The justification for worldwide taxation based on the jurisdiction of incorporation, at least for large multinational corporations, has all but disappeared.

U.S. multinational corporations will now generally be able to deduct 100 percent of future foreign-source dividends received from 10 percent-or-greater foreign-owned affiliates. Prior earnings are a deemed dividend – dividend income with a corresponding increase in basis representing a recontribution to capital for the dividend that is not actually received in cash. The deemed dividend, often referred to as "repatriation," occurs in the last taxable year beginning before Jan. 1, 2018 – that is, for the 2017 calendar year. This applies to any 10 percent-or-more shareholder of a controlled foreign corporation. As a result of the deemed dividend, the repatriated income will be subject to a 15.5 percent tax if the foreign earnings have been accumulated in cash or cash equivalents, and an 8 percent tax on retained earnings that have been reinvested in illiquid assets. The tax can be paid over eight years, with the first payment due based on the original due date of the 2017 tax return (April 15, 2018, in the case of taxpayers with calendar year ends). While this income will also be subject to some state taxes, the coming months should shed light on how, when, and if states will tax these deemed earnings.

While the repatriation and new law applies to all U.S. persons, whether they are a corporation, partnership, individual, or trust, notably absent from this reform is a deduction for income from foreign sources for any person other than a corporation. This preserves double tax treatment for corporate ownership. Concerns over global tax and financial reporting responsibilities raised by U.S. individuals with foreign investments and the estimated 9 million U.S. citizens living abroad were left unanswered. While in some cases global taxation protects the fiscal base, the complex income and disclosure requirements imposed on them need attention.

Unified Gift and Estate Tax

As was the case with President George W. Bush's signature *Economic Growth and Tax Relief Reconciliation Act of 2001*, a permanent change in the gift and estate tax system eluded the drafters of this bill. Like most of the individual changes, the gift and estate tax provisions sunset after eight years. This makes family wealth transfer tax planning difficult and could create unusual, even bizarre, results.

On the estate and gift tax front, the basic and generation-skipping transfer tax exclusions for individuals dying and lifetime gifts made after 2017 doubled to $11.2 million starting in 2018 (adjusted for inflation). The promised and well-advertised permanent repeal never materialized. In 2025, the system reverts to 2017 rules.

Absent future legislation, regulators will be left with the unpleasant task of determining how to treat tax-free gifts using the expanded exclusion during 2018 – 2025 when the exclusion returns to a more modest

amount in 2026. For example, assume the exclusion grows due to inflation to $6 million in 2026. If an individual has already made gifts of $11 million, is the $5 million excess over the new $6 million exclusion immediately taxable? Would that produce a $2 million tax on Jan. 1, 2026? Or will the gifts simply be taxable when the donor dies, leaving an estate with lifetime gifts of $11 million, a taxable estate of $5 million, and, possibly in some cases, no cash? This is a puzzle for the regulators or future politicians to figure out.

Still Looking for a Simpler Answer

The "jobs" part of TCJA was directed at making U.S. corporations competitive again by lowering their income tax rate to global norms. When corporate state and local taxes are factored in, U.S. corporate rates remain a bit high, and it remains to be seen whether the changes will drive a long-lasting boom in the economy. The "tax cuts" part was designed to spread out the cuts to the noncorporate taxpayer. In designing the tax cuts, instead of simplifying the tax system through structural changes, the elimination of brackets, or broadening of the base, Congress added dozens of new technical crevices and a whole new dimension of taxation by creating a rate reduction for certain pass-through entities. The third type of business structure tax is particularly challenging, as it creates a three-way interplay between corporate tax rates, pass-through tax rates, and individual tax rates. As a result, we have a tax reform law that will surely need to be reformed itself very soon.

Practical Planning Tips

- **Act now.** Close the book on 2017 quickly. Use current data to consider restructuring both business and personal plans.
- **Structure.** Carefully review expected revenue streams, payrolls, and capital investments to consider segregating qualified business income from income derived from specified service businesses.
- **Exit considerations/financing.** Consider exit strategies, future capital needs, and whether the lower cost of operations but higher distribution and exit costs to owners merit a change of structure.
- **Pass-throughs.** Monitor the March 15 due date to consider entity classification – check-the-box elections, S-corp, and qualified subchapters (QSub) elections can be made or revoked up to 75 days after year-end.
- **Foreign.** Review all foreign structures and balance the new advantage of tax-free dividend income that remains in corporate formulation versus the single tax structure of pass-through income and foreign tax credits for domestic owners.
- **Gift and estate.** Review estate plans, carefully considering issues related to the step up in basis at death compared to basis transfer when gifting, particularly with respect to appreciated assets.
- **Cash method.** Consider the expanded use of the cash versus accrual methods of accounting and uniform capitalization (UNICAP) for businesses with revenues of up to $25 million.
- **States.** Do not overlook state tax issues; they are now more important than ever.

What Is Not in the Act

Congress has been struggling with tax reform for more than seven years now. Other than international corporate tax reform, the big ideas that would have changed the fundamental structure of federal taxation were dropped, mostly for political reasons, based in some cases on extraordinary pressure exercised by special-interest groups. The following are some big reform ideas that got left out, but will likely surface sooner rather than later once comprehensive reform is in order in a few years.

A **Value Added Tax (VAT)**, which could eliminate 100 million taxpayers from the federal tax rolls but cannot find political backing. In the words of former Treasury Secretary Lawrence Summers, VAT stalls politically because Republicans are concerned that it is a revenue machine that could increase the size of government and Democrats are concerned that it is regressive in nature. The VAT has allowed other countries to make corporations competitive by lowering the tax rate and encouraging global profits. Its proponents claim that it should not be ignored.

The implementation of a **Border Adjustable Tax (BAT)**, championed by economists Alan Auerbach and Douglas Holz-Eakin. The BAT would have eliminated the deductibility of imports and excluded exports from the tax base. It would have taxed consumption, and would be extraordinarily similar to a VAT (some say better). It was the cornerstone of the original 2016 “A Better Way” blueprint for tax simplification. Arguably, it was too good to be true, and perhaps a modification limiting the BAT to 50 percent of taxable income before the adjustment would have provided a palatable revenue source without overly taxing retailers and energy companies to fund reduced corporate rates. Instead, the limit on SALT deductions became the source of new federal revenue.

Mark-to-market taxation, promoted in mid-2017 by economists Eric Toder and Alan Viard at the Tax Policy Center, with the support of the Urban and Brookings Institutions. Mark-to-market taxation would have applied to most corporate holdings, particularly marketable securities.

Corporate integration, championed for many years in various forms by Sen. Orrin Hatch (R-Utah). Integration provides for either a tax deduction for dividends or a pass-through of taxes paid by a corporation to provide tax relief to individual investors. It also taxes income when the business earns it, and apportions and allocates some corporate tax cost to nontaxable domestic and foreign investors that would not normally be subject to income tax.

Learn More

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