Tax Reform or Tax Cut?

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What happened on the Hill?

- On Thursday evening, the Senate passed a budget blueprint that will support a $1.5 trillion in tax cuts over the next decade with only GOP support (in the fine print, there will have to be cuts to Medicare and Medicaid.)

- This budget blueprint was sent to the House this week. There will be some resistance to a tax plan that is not revenue neutral.

- Remember - Tax Reform may not proceed until a Budget is passed (and theoretically, Congress agrees to how much healthcare costs are projected to be.)

- Constituencies are actively lobbying Congress to protect deductions they value and want to maintain

- Odds of permanent tax cuts look dimmer

What does the public think about a tax cut?

- Tax reform is not a priority for the majority of Americans - less than 2% list it as #1

- Tax reform is the TOP priority for business groups and GOP donors

- Reducing taxes for the wealthy is extremely unpopular (62% oppose)

- Raising the budget deficit is unpopular though deficit reduction is not a priority (43% of likely voters were against a tax cut that increases the deficit.)

- A tax cut that benefits the middle class and raises the deficit will likely be acceptable to the majority of likely voters

SALT

- SALT - State And Local Taxes - on individual returns eliminated?
- Impact of the elimination of the deduction of SALT will be difficult in “blue” states (NY, NJ, CT, CA, and IL) with high income and real estate taxes.
- If the Standard Deduction on a MFJ return is $24k, this should cover the major itemized deductions (mortgage interest, real estate + state income taxes, & charitable contributions) in most of America.
- Proposals are being discussed to limit the deduction on SALT for those earning more than $200k annually, or allowing the real estate tax deduction but disallow state and local taxes.
- Definition of “middle class” varies significantly by geographic locations.

Mortgage Interest Deduction

- For now, it remains with no discussion of limiting or reducing the deductibility.

- However, bankers, mortgage brokers, and home builders are “fussing” about the increase in the Standard Deduction to $24k on a MFJ return as they feel there will be less incentive to buy a home.

- For middle class taxpayers, the average interest deduction is approximately $7k as well as the SALT deduction of $7k (combined are lower than the proposed Standard Deduction of $24k or $12k for Single filers)

Limit contributions to 401(k) plans?

- Over the weekend, we learned that Congress is discussing limiting the contributions to 401(k) plans, possibly to as low as $2,400 annually.

- This deduction from pre-tax income is valued at approximately $115 million annually. For 10 years, this would be a substantial savings towards the planned tax cut.

- Financial institutions are already raising red flags as they feel many employees will not contribute.

- Tax policy experts are firmly against this as it is felt to be truly “a bad tax policy” decision.

Corporate deductions

- Full expensing for 5 years (depreciation) with exception for real estate
- Eliminate the deduction for business interest expense….. Exceptions are already being discussed for farmers and ranchers, land purchases, and utilities.

Pass-through businesses

- Most businesses are pass-throughs - Of the 26 million businesses in 2014, 95% were pass-throughs, while only 5% were C-corporations. These are partnerships, S-corps, or sole proprietorships and taxed as the owners' personal income.

- Almost all businesses are small - In 2014, 99% of all businesses had $10 million or less in sales or revenue

- Pass-throughs are not necessarily small businesses - examples: law firms, accounting or consulting firms, and investment firms

- Pass through businesses now earn a majority of business income - in 2013, 44% of business income was earned by C-corps

- Pass-throughs often pay lower tax than C-corps - an incentive to un-incorporate and organize as an S-corp or a partnership (especially if the new provisions are passed.)

Pass-throughs (cont'd)

- The growth of pass-through businesses has eroded corporate and payroll taxes - if pass-throughs were C-corps in 2011 and taxed accordingly, they would have generated an additional $100 billion in tax revenue.

- Pass-through income is primarily earned by high-income individuals - Approximately 70% of partnership income accrues to the top 1% as compared to 11% of wages

- Pass-through businesses are responsible for a significant share of the tax gap - 41% of the tax gap from 2008-2010 ($190 billion in tax revenue) was due to underreporting of income of pass-throughs

- **Why are these facts important? Tax plan intends to cap tax rate on pass-throughs at 15-25%**

Taxation of Foreign Corporations

- There are discussions regarding surtaxes on foreign corporations on their US source income.
- Alternatively, there may be a limit on how much foreign corporations are able to deduct on certain US expenses such as rent, royalties, and interest on debt
- Congress intends to enact rules to “level” the playing field between US HQed parent corporations versus overseas HQed parent companies.
- Top tax rate may need to be 23% versus the 15% originally proposed.

Move to a Territorial Tax System?

- While the Border Adjustment Tax has been dropped, there is a new attempt to lower the global tax liability for multinational corps.
- No deferral of tax on income earned abroad
- No penalty for repatriating cash "parked" overseas
- A move toward a "global minimum" tax with profits earned overseas taxed at a lower rate, possibly 15%
- Intent not entirely clear in the initial language as there will be a specific tax rate applied to ALL overseas income with specific language on deemed tax avoidance by shifting income earned abroad to tax havens - example: corp income earned in China taxed at 40% will be added to income earned in HK or Singapore at much lower rates before the tax rate is applied. Not enough specific information available at this time.

Rhetoric versus facts

#1 - *“America is the most highly taxed country in the world.”*

US taxes as a % of GDP = 26.4% while the average OECD tax as a % of GDP = 34.3%

#2 - *“Estate tax is destroying farmers and truckers.”*

5,200 of the 2.7 million estates (0.2%) will owe any estate tax and only 50 of these taxable estates are small farms or businesses

#3 - *“Taxation of pass-through entities is a burden to small businesses.”*

High income doctors, lawyers, consultants and other professionals such as partners in hedge funds or investment firms would be taxed at a flat 15-25%

Rhetoric (cont'd)

#4 - *"Taxes on business profits reduce wages of workers."*

Will corporations pass the benefit of lower taxes to workers….? Kevin Hassett has calculated a 15% corporate tax rate would add $4,000 to workers income while most economists calculate the benefit at $400-$800 per worker.

#5 - "*Repatriating overseas profits will create jobs."*

This didn't happen in 2004. There are no plans to tie any conditions to repatriated cash.

#6 - *"This is not a tax cut for the rich."*

Almost impossible as certain groups will definitely benefit.

#7 - *"It's a big tax cut for the middle class."*

This depends on the definition of middle class dependent on the final regulations on the SALT deduction as well as the Standard Deduction.

Rhetoric (cont'd)

#8 - *"The tax plan will not increase the deficit."*

Cuts in corporate taxes, elimination of the estate tax, lower rates for some high-income earners, and a massive loophole for pass-throughs = a multi-trillion dollar budget buster.

#9 - *"Cutting taxes will jumpstart growth."*

There is really no evidence to support this. Investors will likely be the key beneficiaries of this tax cut.

#10 - *"Tax cuts will pay for themselves."*

Reagan tax cuts led to large deficits while Clinton tax increases led to surpluses. Spending is the ISSUE!

Questions?

Sources used:

NY Times

Wall Street Journal

Washington Post

Brookings

AICPA

Tax Policy Center

Mercatus Center

FiveThirtyEight