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THE NEW TAX LEGISLATION

Background: On December 19, 2017, President Trump signed the "Tax Cuts and Jobs Act of 2017," which will be referred to herein as "TCJA."

1. New Tax Rates and Deduction

This legislation has made some significant and radical changes in the tax law that we have not seen in more than thirty years. The law affects primarily corporate and other business taxpayers, which receive an extraordinary financial benefit through the tax cuts. This should have a modest effect on the average individual taxpayer, but represents a huge tax increase for the relatively wealthy individual taxpayer.

The tax benefits were awarded not only to corporate taxpayers, but to other business entities operating as so-called flow-through entities, such as limited liability companies, S Corporations and even sole proprietorships. They received the largest deduction in their income taxes since the enactment of the 16th Amendment to the US Constitution on March 15, 1913. Specifically, prior to the TCJA, the corporate tax was progressive to 35% at the highest income level. Now these progressive rates applicable to business income have been eliminated: all corporations actively engaged in business pay a flat rate of 21%. This is important because this rate will be lower than the highest individual rate. Of course, so called C-Corporations, which are not taxed as flow-through entities, are still are set to be-doubly taxed, in the sense that the company pays its tax on income and when it distributes dividends to its shareholders, they are then taxed individually. Smaller companies can elect to be S Corporations, which is a flow-through entity taxed essentially like a partnership or a sole proprietorship: there is only one tax on the business income. The tax rate on a dividend distributed by a C Corporation is a flat 21%. This is true for public corporations' dividends as long as the dividend is "qualified." I estimate that about 85-90% of public dividend-paying corporations issue qualified dividends. That is a substantial advantage over paying interest on bonds, which is taxed to the creditor at whatever the individual's maximum tax bracket is. The pass-through entities, like Subchapter S-Corporations, partnerships and proprietorships, are now entitled to an income tax deduction of 20% for their business income, so an entity is subject only to a single tax between the company and the shareholder, partner or individual proprietor. However, there are a few qualifications to receive this 20% deduction. They are:

a) The income must be earned in the United States
b) This deduction applies only for tax years 2018-2025
c) The deduction applies only to taxable income under $315K on a joint return or $157,500 for single filers.

Even trusts and estates can qualify for the 20% deduction. But certain professions are excluded; those include in law, health, accounting, performing arts, investment management and some other service businesses. However, engineers and architects are not subject to this restriction! I assume the authors of this bill thought that doctors, CPA's and lawyers are less important to society than individuals engaged in building something – engineers and architects. It was the same logic that treats the sale of patents as long term capital gain, but the sale of copyrights as ordinary income. Inventors are more important than writers, it seems.

2. Business Property Purchases

Another benefit relates to business property purchased during the year. Previously, property used for a business was allowed to be written off at 50% in the year of purchase, up to $500K. That figure has now been increased to allow a $1M deduction, but it is phased out with income above $2.5M. Again, this tax benefit is available only for the tax years of 2018-2022, with the exception of "long production" property and certain airplanes.

3. Deficits and Inflation

The economic effect of the foregoing business changes are complex, but certain outcomes are likely:

The limitation of the corporate tax rate to 21% will inevitably increase significantly the enormous deficit already plaguing the United States. Our national debt at yearend 2018 was $22 trillion, and under the new tax legislation we will be adding to that deficit at the rate of $780 billion per year. How will we finance this? A lot will depend on foreign governments, especially China, to fund the deficit. Whether they will continue to do this is far from certain. Negotiations for tariff relief, protection of our copyright laws, plus manipulation of the Chinese currency continue to be significant outstanding areas of disagreement between this country and China. One thing that China has not threatened, but is certainly available to them in the ongoing negotiations, is not to finance a significant part of our deficit. If so, the question arises who is, ever, going to pay back the money we are borrowing from our descendants? Of course, the government can print all the currency it wants, but that has its own hazards, i.e. an acceleration of underlying inflation. One only need to look at a country like Nicaragua, with its enormous inflation, to see what significant damage can be inflicted on an economy that does not have a responsible budget. Indeed, my ancestors in Germany experienced runaway inflation of several thousand percent per year, so that many individuals were reduced to bartering to survive. Fortunately, my family, being in the wine business, had something to exchange for the necessities of life. But, many farmers were not that fortunate, and relied on manual labor to support themselves. In those situations, individuals tend to spend what they are paid on the payment date, because tomorrow the prices will be higher. I don't foresee that kind of inflation in the US, but in the long run, as money loses its purchasing power, inflation is an inevitable consequence. In our lifetime, we have seen a phenomenon in the Bay Area where housing prices have in some instances, increased tenfold in 40 years. Inflation is somewhere akin to termites – the damage is ongoing, but invisible and unnoticed, until one day the structure collapses. It would be prudent for the government to start thinking about a balanced budget for future years, although realistically, from a political standpoint, that is not a likely outcome. One could only hope that the rate of inflation is controlled by the Federal Reserve Board, responsible legislators and the Administration.

4. Individual Tax Payer

Many of you are already familiar with some of the good and bad news that the TCJA enacted for individual taxpayers. For the working individual of modest income there is a reduction for the years 2018-2025 for individuals making more than $90,525. These middle class American's are subject to progressive rate increases, but the rates have been reduced to 10, 12, 22, 24, 32, 35 & 37%. The TCJA dramatically altered the income factor to which these rates are applied. For example: the 35% rate formerly applied to about $425,000 of taxable income; now it applies to income between $200-500K. These margins are indexed for inflation at the beginning of the year and will continue until 2025. Note that the highest bracket's rate has been reduced from 39.5% to 37%.

Also, any capital gains rates of Americans making less than $425,000 or $479,000 for married individuals filing jointly, are indexed for inflation. The maximum capital gains rate for wealthy Americans is 20%, and 15% on qualified dividends if the taxpayer makes less than $425,000 and $479,000 jointly. Above that level, dividends are taxed at 20%.

Other minor benefits for middle income tax payers are: Education IRA Coverdell (education savings account) increased maximum contributions from $500 to $2,000 per year. Distributions are tax-free if used for education expenses such as room, board, tuition, etc. However, $2,000 per year contribution is phased out for single taxpayers earning $110,000, and $220,000 for married taxpayers. In short, this is not a significant benefit for middle-income taxpayers.

5. Section 529 Plans

A much better alternative are the so called Section 529 plans, which formerly applied only to college savings plans, they apply to tuition, room and board. Distributions are tax-free to the student if used for these purposes. The tax act broadened the scope of Section 529 to include tuition at public, private, religious, elementary or secondary schools, but limited the amount to $10,000 per student during the taxable year. Contributions to the Section 529 plan are not deductible, but they are also not taxable to the student, either at the time the contribution is made, nor at the time the student takes the funds out of the account and uses it for so-called "qualified education expenses." Note that the $10,000 limitation is per-student, not per-donor, so if one has children or grandchildren the statute provides no limit on how many Section 529 plans one can set up for each student.

The law provides that if the student does not use part or all of the funds completely within the 529 plan, those amounts can be shifted to another student's plan.

There are extensive regulations about how these Section 529 plans are invested, plus those in the state in which the donor resides.

The principal tax advantage to the donor is that a 529 qualified tuition program is exempt from income tax. So an individual could start his or her child's college education fund by establishing a 529 plan when the child is born. By the time the child reaches college eighteen years later, he or she would receive $180,000 in contributions plus, on a tax-free basis, the dividends, interest, capital gains and other income earned by the tuition program during its existence. Given the astronomical costs of most college education today, this is a feasible way to save money to educate a child or grandchild.

Some of the technical requirements are that contributions to this 529 plan must be:

1. Made in cash
2. Each program must be separately accounted for each designated beneficiary
3. The donor and beneficiary may direct the investment of contributions to the program where the funds are custodial, but not more than three times in any calendar year. Many state offer a state-managed fund just for these plans.
4. The program must not allow using the securities as collateral for a loan
5. Other than the tax-free appreciation which should occur over a period of time while the funds are in the qualified plan, another tax advantage is that neither the beneficiary nor the contributor has to pay tax on the earning of such a program. It is also exempt from gift tax.
6. Any excess contribution for the year is taken into account rateably over the five year period at the beginning of the calendar year, if the donor exceeds the limitation for the year and elects that option.
7. If the distribution is used for higher education expenses, the amount not used for that purpose is taxable income to the beneficiary.
8. The student is free to roll over the amount in the education fund to another qualified tuition plan for a different beneficiary who has such a plan, and who is a member of his or her family. So if your daughter or grandchild drops out of college, the funds can be transferred to some other person without tax.
9. Each officer or employee who has control of a qualified education program must make a report regarding such a program to the IRS with respect to contributions and distributions. State-sponsored plans take care of that.

   A taxpayer could theoretically have both a Coverdell (ESA) education savings account under Section 529.

6. Limitation on Deductions

Some of the benefits for individual taxpayers do not apply to wealthy individuals. For those fortunate taxpayers, there are now substantial limitations on deductions. These include:

The standard deduction was increased from $13,000 single to $24,000 for married tax payers on a joint return. The "price" exacted by Congress included the elimination of the former personal exemption, and a reduction of most itemized personal expenses. Congress intended that the majority of individuals who formally chose to itemize would now use the standard deduction, and only occasionally find it useful to itemize. An example would be in a year in which medical expenses or charitable deductions were very high and exceeded the $24,000 standard deduction, the TP would elect to itemize.

7. Mortgage Interest

Another way to finance the large standard deduction was by imposing limitations on the mortgage interest deduction, which has been used by millions of tax payers to assist in the purchase of a home. Now, if the mortgage existed before the enactment of the new law, an individual may only deduct the interest on $1 million of debt for the first, second or third home if the debt was structured before the new tax law was passed. However, on newly-purchased properties the interest is deductible only to the extent of a $750,000 mortgage. That may be generous in parts of the country where housing is still inexpensive; but in the Bay Area $750,000 is more like the deposit or down payment with the offer, rather than the price of the building. Since the standard deduction encompasses mortgage interest, many taxpayers will probably opt to take the standard deduction rather than itemizing mortgage interest.

8. State & Local Taxes

Another painful modification to the tax law for individuals is the new limitation on state and local taxes. This applies not only to property taxes, but also state and local income taxes, including taxes on tangible personal property, such as cars. Although there is no reference to this in the legislative history of the TCJA, my impression is this legislation was aimed at the East and West Coast states with the highest personal income taxes which, for the most part, did not support the present Administration in the last election.

A California taxpayer with high income who pays, say $100,000 of state income taxes, plus property taxes, 90-95% will not have a tax-deduction for the full amount for federal purposes even if they itemize. Persons who own multiple personal properties (i.e. homes) would for the most part have no tax deductions for their property taxes, and very little for the interest on mortgages, if any. For many high income individuals, the combined effect of this limitation is a substantial increase in their federal taxable income, effective this year. However, if the properties are investments – not residences - then the property taxes will be deductible.

9. Miscellaneous Itemized Deductions

Another new limitation that is imposed on itemized deductions which were previously subject to a 2% floor. This includes the expenses of investments, such as fees of money managers, safe deposit boxes, lawyers and accountants employed with regards to investment models, tax preparation fees, the home office deduction, and unreimbursed employee expenses. This applies for years 2018-2025. I suggest that this limitation is quite unfair, because the government takes a share of dividends, interest, capital gains, etc. Until now the investor who earns these items could deduct the expenses incident to producing these earnings.

10. Disaster Losses – this section was repealed by TCJA

Examples of such an event were disruption or destruction by fire, wind storm, tornado, etc. of the taxpayer's property. There was no requirement that the property be used in business. In most cases in fact that was not the case. For example, in 2018, during the Napa County Paradise fires, taxpayers could deduct most of the casualty loss. That would not provide a fund for repairs and replacements, but at least it freed the taxpayer from paying his/her income tax in the year they were subject to such a highly abnormal event. In short, the taxpayer received a substantial amount of tax relief from the casualty loss. This section has now been repealed: there is no longer a deduction for passed casualty losses. That means that in a year where the taxpayer will have both the tax liability for his or her ordinary income and capital gains – the unusual situation, but would also have to find the funds to rebuild the destroyed property. I submit that very few individuals are in the financial position to suffer that kind of a loss and pay their taxes in full. To avoid the financial catastrophe, from a planning standpoint, the taxpayer must insure against possible property casualty losses, if such coverage is available.

11. Alimony

The law changes the deductibility and taxability of the alimony deduction. Starting this year the payor may not deduct any alimony payments and the payee no longer has to pay income tax on the payments. This change should make it more difficult to effect mutually acceptable divorce settlements, since now alimony must be paid with tax-paid dollars. The government benefits only to the extent that the payor is in a higher tax bracket than the payee. To the extent that both individuals are in the same tax bracket, the change in the law is a wash.

12. Estate Tax Exemption

The upshot of the foregoing is a substantial increase in income taxation for wealthy individuals. They still do receive one major benefit however, which unfortunately is not available during the taxpayer's lifetime; the new law kept the old 40% tax on the estates exceeding the exemption amount. That amount was approximately $5.4 million in 2018; or the TCJA exemption has doubled. It allows an individual's $11.8M to be passed by will over his or her lifetime without incurring a federal transfer tax. For a married couple, roughly $22.3M is exempt before there is a taxable amount. Note that:

a) The 40% tax applies to estate, gift and generation-skipping taxes at over $ 1 million, and begins at 18% over the exemption amount.

b) The increase in the exemption only applies for the years 2018-2025

c) The law allows "portability," which simply states that any amount not used on the death of the first decedent can be used by the estate of the second.

d) The annual exclusion remains at $15K, for community property gifts, that amount is $30K. [The interest of both spouses is "present and equal" under the California Civil Code.]

13. Estate Planning

What the foregoing means in terms of estate planning is that a lot of the complicated plans, multiple trusts, defective grantor trusts, etc. are no longer necessary. If the total assets of a married couple are less than $22M (which would describe more than 99% of the individuals in the US), then complicated estate planning is no longer needed. Also, there is no great benefit for making charitable contributions other than from a humanitarian standpoint, because the charitable deduction is not needed to reduce the estate tax in most estates. And if the assets exceed $22M taxpayers can continue to make annual gifts to as many individuals as they like, limited to $30K for each family in the case of community property donors.

There is also some estate planning available which has no tax consequences as such, but which can reduce the tax on estates significantly. An example would be shifting opportunities from the taxpayer(s) to their children or other beneficiaries. Individuals starting companies often make their children – even their minor children - beneficiaries and shareholders of the company. If that business is successful later on, a substantial amount of value has been shifted tax-free from the parents' estate to the children's. Also, for really large estates, the estate tax still allows private foundations to be beneficiaries to allow the family a tax deductible way to continue to support charitable organizations after the demise of the parents. Sophisticated estate planning indicated for very wealthy individuals, and their scope is well beyond the topic of this talk, and the marital deduction exempts 100% of spousal gifts and bequests from federal estate tax.

14. Stepped up Basis

Finally, one IRC section that is very important for tax planning, which fortunately did not change, is the so called step-up basis under IIRC Section 1014. This allows, in effect, the forgiveness of any appreciation in an asset which occurred during the decedent's lifetime. Example; an individual who bought a house in San Francisco for $250K forty or fifty years ago, and the home is now valued at $10M, that increase in value is not subject to income tax on the descendants death. The survivor receives a new stepped-up basis of $10M and he/she is free to sell the home for that amount without paying income tax and if the estate exceeds $22M, the estate planner can include a deduction by the terms of any assets left to the surviving spouse which qualifies them to Section 2056 is free of tax.

To illustrate the importance of this provision, assume someone like Bill Gates might have $1B worth of Microsoft stock which he acquired when the company was founded; the value then was virtually zero – its cost basis. If he dies and leaves his assets to his widow, there is no income tax on the appreciation of the stock because of the stepped-up basis, and no estate tax because of the marital deduction. Mrs. Gates is then free to sell those assets for cash without incurring any federal or state income taxes. When the survivor dies - unless he/she remarries – there will be an estate tax on the excess over the exemption, but there are many ways to reduce even that liability by sophisticated estate planning.