Trick(le) of the Tax Trade

written by HOWARD SHWIFF

Despite some wins for local property owners and big business, overall our columnist doubts the logic of the "trickle down" theory behind the recent federal tax overhaul.

The new federal tax law is not half bad—it's worse! My estimate is about 70 percent terrible tax policies. The good news is that the 30 percent that is not terrible is generally good for rental property owners, directly or by macroeconomic side effects, and it will be great for the Bay Area.

The positive spin is that the 2017 "Tax Cuts and Jobs Act" (TCJA) is using lower-taxed corporate profits, minimally taxed repatriated funds, and enhanced Section 179 deductions to encourage business investment in production. Also, TCJA uses lower personal taxes, a 20 percent deduction for reduction of business taxable income, and a waiver of estate taxes for many more high net worthers to encourage investing and spending. Finally, TCJA takes a base-hit swing at deficit reduction with the near elimination of "Obamacare" subsidies to the middle class and their insurers. The Dow today is over 26,000; Wall Street is betting TCJA is a formula for growth.

But, in my opinion, the reality is that TCJA is just plain bad for balancing the gargantuan U.S. budget.

The corporate tax rate is being cut from 35% to 21%. All things being equal, that reduces revenue from corporate taxes by 40 percent. That's a bigger reduction than any recession. A budget that is based on reducing corporate tax dollars so much, hoping for a trickle into higher wages for all people, while also lowering top-bracket tax rates and not taxing the accumulation in the estates of the quite wealthy, simply cannot be balanced.

Below is a more in-depth look at the good, bad and ugly new provisions in the 2017 TCJA, and the corollary economic impact. Let's track the provisions as if we were filling out our 1040 Individual Tax Returns. Keep in mind, most provisions of TCJA are temporary. They are set to expire after 2025, unless extended by Congress.

W-2 Wages & Salaries

A salary is nice, but income from a passthrough entity just got a lot better.

Schedule B: Taxable Interest Income

Investments providing somewhat higher interest income should be available soon because the Federal Reserve, the central bank of the U.S., in performing its functions to promote the effective operation of the U.S. economy and the public interest, will certainly follow drummer Trump and raise Fed Funds interest rates to banks. I've already seen a whopping 2 percent offered on CDs. That's "good" only if you believe the U.S. Bureau of Statistics, which says the national CPI change over 2017 was 2.1 percent (2.9 percent for the Bay Area).

Schedule B: Dividends from Stocks

Congress hopes that lower corporate taxes and a portion of those untaxed "repatriated" funds will trickle down in the form of dividends. So far, only big bonuses have been announced, and guess who's getting the lion's share? (See below: "Repatriation Holiday.")

Schedule B: Dividends from REIT

If your real estate portfolio is diversified with REIT holdings, those dividends get a break. Under TCJA, REIT shareholders and partners in publicly traded partnerships can generally deduct 20% of so-called "qualified business income."

Business Income

For businesses, highlights of the TCJA include the following: TCJA eliminates the graduated corporate tax rate structure and instead taxes corporate taxable income at a flat 21% rate; there is an increase in amounts that may be expensed under "first-year bonus" depreciation and Section 179; there is a new business deduction for sole proprietorships and passthrough entities; the corporate alternative minimum tax has been eliminated; and repatriation (more on this below). Unlike the provisions for individuals, which generally expire after 2025, the business-related provisions in the TCJA are permanent.

Bonus Depreciation

To encourage "small" businesses to purchase equipment, TCJA increases the maximum amount a taxpayer may expense under Section 179 to $1 million, plus it put in "bonus depreciation" up to another 100 percent through 2022, on top of taking the regular depreciation. Reaching the $2.5-million purchase limit has some effect, but shoot for that first and take a $2,070,000 write-off for the purchase year.

TCJA also expands Sec. 179 expensing (100 percent depreciation in year one to include the cost of improvements to nonresidential property, such as roofs, HVAC, and fire protection/security systems). TCJA even expands the Sec. 179 property definition to include certain depreciable tangible personal property used in connection with furnishing lodging properties.

New 20 Percent Deduction for Qualified Business Income

You cannot take real advantage of deductions unless you are set up to do business and receive income as a "Passthrough Entity." If you are a sole proprietor, a partner in a partnership, a member (partner) in an LLC (taxed as a partnership), or a shareholder in an S corp, Section 199A of the TCJA provides a new deduction for qualified business income. Trusts and estates are also eligible for this deduction. The amount of the deduction is generally 20 percent (before limits are applied) of the taxpayer's portion of the qualifying business income from a qualified trade or business.

These provisions are, however, some of the most complex in the new law. When the IRS does its thing for 2018, the deduction for qualified business income will probably be claimed by individual taxpayers on some new line on 1040 Page 2, after it's calculated on some new Form X. There are lots of limits and restrictions your CPA will have to calculate.

Schedule E, Line 17: Income from Rental Real Estate, Partnerships and S Corps

For rental property, property taxes and mortgage interest remain fully tax-deductible, and depreciation is about the same. In my book, any depreciation is a sweet non-cash expense. TCJA slightly reduces the deduction for depreciation by adding a couple of years to the standard schedule for depreciable lives. If you have "big" properties, check out the alternative depreciation system (ADS) under which the recovery period for residential rental property was cut from 40 to 30 years.

Schedule A, Itemized Deductions

Here is Congress's only tax-simplification strategy: without state and local income taxes and 100 percent mortgage interest deductions, many taxpayers who previously itemized deductions will now have to settle for claiming the standard deduction. This means they may not have to file Schedule A. However, taxpayers should continue to track their expenses, so they can compare and choose the larger tax deduction.

Medical and Dental Expenses

These remains deductible, and the adjusted gross income threshold for medical and dental expenses (MDE) has been reduced to 7.5% of AGI for 2017 and 2018. The threshold used to be 10 percent and in 2019 the threshold will revert back to 10 percent, so lawmakers have given us an incentive to get sick now. MDE have always been a financial pain reducer for people sick enough for their MDE to exceed the AGI threshold. Under TCJA you may need to get considerably sicker before the opioid effect of MDE kicks in. Fortunately, in California, medicinal marijuana can be prescribed, without having your CPA call a doctor.

Mortgage Interest Deduction

Unlike all those benefits we use on Schedule E for our "investment properties," those who buy a (Bay Area) home in 2018 for, say, $1,500,000, with a $1,000,000 bank loan, are fresh out of luck. Home owners are now limited to deducting the interest paid on a maximum $750,000 of their loan, and there is no deductible interest on a home equity loan. Taxpayers with a home mortgage taken out before December 15, 2017, can continue to claim interest on up to $1 million, plus interest on up to $100,000 on home equity lines.

Property Taxes

The new TCJA caps the combined total possible state and local tax (SALT) deductions at $10,000. That includes California state income tax, sales taxes paid to the state and local municipalities, real property taxes on our homes, and personal property taxes on our cars. Personally, the cap will cut my former ration of SALT in half; how about you?

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Standard Deduction

Finally, we come to Congress's tax simplification strategy. TCJA increases the standard deduction to $24,000 for married couples filing jointly. Why bother itemizing, with maximum $10,000 SALT deductions and maybe home loan interest of $30,000 to deduct? For those with Proposition 13 taxes and a paid-down home loan, itemization may no longer be possible.

That brings up the side economic benefits for residential landlords: pre-TCJA loan underwriting assumptions about after-tax income are out the window for soon-to-be strapped young families, so they will likely be renting from us again in just a couple years. If they get foreclosed on, you may be able to acquire some bargain foreclosures to turn into rental houses, making the interest and property taxes once again fully deductible. Generally speaking (maybe not in San Francisco) would-be buyers may choose to continue renting, and that will be good for keeping vacancies low and pushing rents higher.

1031 Exchanges

Washington loves capital gains taxes, so they tried to end all like-kind exchanges (used for tax deferral on built-in gains). But our lobbyists (like the National Association of Realtors and the Federation of Exchange Accommodators) prevailed as far as real property goes.

TCJA did not reduce the capital gains tax rate, so exchanges are still a great strategy. Part of estate planning is to defer gains for decades and ultimately escape taxation entirely when the "basis is stepped up" to fair market value as you go through the pearly gates. Exchanges also allow you to borrow the tax chunk from Uncle Sam and use it interest free, hoping to reap appreciation on a larger equity investment.

But the writing may be on the wall for 1031s, so consider doing your exchanges sooner rather than later. Or wait, maybe you should wait a year or two to exchange into property at higher cap rates? TCJA gives Trump's new Fed chair support for raising interest rates, which in turn may raise cap rates. Today's typical exchange into a true credit-tenant, totally passive, triple-net 20-plus-year lease transacts at about a 5 percent cap rate.

Section 179 for Business Personal Property

The exchange treatment on personal property gains was lost, but a new Section 179 provision gives it back by allowing "full expensing (technically a first-year 100 percent bonus depreciation allowance) for most tangible personal property." But buy quickly, because that 100 percent gets phased out. Anyway, who has ever had a gain on selling their auto, truck or farm machinery?

Actually, full and immediate expensing (cost recovery) for business investments is sound economic thinking. It can churn billions of dollars back into circulation, increasing the velocity and number of investment transactions happening in the business market place.

Tax Brackets for Individuals

Your Line 43 taxable income will likely fall into a tax bracket with a lower scheduled tax rate. But that's only for the next eight years, after which the schedule will ratchet back up to 2017 rates. Then rates will most likely have to be set higher to bail us out of what I imagine to be an enormous deficit.

Remember, federal income tax rates get progressively higher as applied to progressively higher chunks of your taxable income. In TCJA, the rates per chunk of income have been lowered, and the chunk breakpoints have been changed. Generally, your taxable income chunks will be hit with lower rates than before, about 2 percent to 3 percent lower per bracket. For example, under TCJA, there is a rate of 24 percent of taxable income between $165,000 and $315,000. At the highest tax bracket, over $600,000, the rate is 37 percent. It's that last chunk that kills any chance of a decent U.S. budget. Lowering the top individual rate from 39.6% to 37%, and having that rate kick in after a higher $600,000 taxable income level wipes out a ton of U.S. revenue.

Chained Consumer Price Index

CCPI is the new weak link. Inflation indexing of income tax brackets, various deductions and many other items will be adjusted annually using a "chained consumer price index" that is expected to grow more slowly than the previous inflation measure. This may result in lower inflation adjustments, and thus smaller annual increases than using the current CPI index. Mathematically, the chain CPI has a weak link to reality and will most assuredly result in a hidden hike to taxes over time.

Tax Bracket for Businesses

Regular "C corporations" will pay tax at a flat 21% rate, down from the current 35% top rate, and this lower corporate rate is permanent. Plus, lawmakers killed the corporate AMT altogether, unlike what they did to the AMT for individuals.

Repatriation Tax Holiday

Repatriation (Section 965) is designed to incentivize U.S.-based multinational companies that do big business overseas to bring those stockpiled foreign profits back home and inject it into our economy. Repatriation offers a now-or-never, one time only, very low tax on previously untaxed earnings that have been accumulated (loophole tax evasion) in overseas accounts. Depending on asset liquidity, the tax rate will be 8 percent to 15.5 percent, payable over eight years, without interest charge.

It's estimated that $250 billion might be repatriated, from the whopping $2.5 trillion of capital stashed internationally. To work for the economy, the repatriated funds need to be reinvested in core businesses, but reinvestment is not a TCJA requirement, so some me-first businesses have their eyes on bonuses, driving stock prices higher with stock repurchases, or both.

Tech and healthcare sectors are the major beneficiaries. Many of these companies are headquartered or doing big business in Silicon Valley and the Bay Area, making our area TCJA's big economic beneficiary.

Repatriation sounds more like a one-time get-out-of-jail free card for vast untaxed profits socked away in overseas accounts.

Bring it home during the holiday, and pay a nominal tax on that net profit. Bonus some of it out to the CEOs and CFOs because they astutely hid the profits from taxation, and when they spend those bonuses on a new Tesla, something is bound to trickle down.

Turns out that Congress and the Fed are still gamblers on the “trickle down” theory that tax benefits showered on corporations and the wealthy will translate into faster economic growth followed by higher wages, then increased personal consumption, all adding up to improved quality of life for the vast middle class, or at least for high net worth families. Which brings us to …

Estate Planning

TCJA upped the estate and gift exclusion big time, doubling the exclusion to $11.2 million for single filers and $22.4 million for married couples filing jointly. TCJA certainly gives extra wiggle room to avoid any 40 percent estate tax. At these exclusion levels, far fewer estates will be subject to estate taxes, but be optimistic about appreciation, and plan on deficit-driven inflation.

Again, be aware that, as with most of TCJA, these higher estate tax exemption amounts “sunset” or revert to 2017 levels after 2025, so gift away if you plan to live past the sunset. Any family who can afford to do so should use their exemption for gifts within the next eight years, in case it actually does sunset. (Dying early is not recommended.)

Bottom line

Two things everyone agrees on: first, this is not a tax simplification act. (So don’t buy TurboTax and fire your CPA.) Second, run, don’t walk, to see an attorney who sets up passthrough entities (LLCs & S-corps) to evaluate your holding structure(s). The line is going to get very long very soon.

One final thought: despite the levity I have tried to bring to the topic, this Tax Cuts & Jobs Act is no laughing matter.

The views expressed by the author are the author’s alone and do not represent the views of any firm. Howard Shwiff has an MBA in Urban Economics. He is a California real estate broker, CCIM and CPM. His opinions are not necessarily the opinions of Shwiff, Levy & Polo, LLP.