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TCU Professor Give the Lowdown on the Tax Bill's Impact on Business - *by Robert Francis*

The Senate is barreling toward the most sweeping rewrite of the tax code in more than three decades with the top Republican senator saying he was willing to compromise on a major sticking point for lawmakers from high-tax states such as New York and California.

The Senate voted 51-47 to formally begin negotiations with the House to reconcile their two tax bills. Days and nights of tough negotiations await.

GOP leaders are pushing to send a final blended package to President Donald Trump before Christmas.

Republicans see the tax overhaul as a pressing political imperative to preserve their majorities in Congress in next year's elections.

Before the Senate vote, Senate Majority Leader Mitch McConnell, R-Kentucky, said he favors expanding a deduction for state and local taxes to let Americans deduct local income taxes as well as property taxes.

The proposal is a possible solution to a standoff with rebellious House Republicans from high-tax states. The tax bills passed by the House and Senate would end deductions for state and local income and sales taxes, while allowing only a deduction of up to $10,000 for property taxes.

The House and Senate bills both would provide steep tax cuts for businesses and more modest tax breaks for families and individuals. The tax cuts in each bill add up to about $1.5 trillion over the next decade.

Rep. Kevin Brady, R-Conroe, chairman of the powerful House Ways and Means Committee, said negotiators are looking at several options to help people who live in high-tax states, including expanding the state and local tax deduction to include income taxes.

Brady said lawmakers are also considering adjusting the tax rates and tax brackets, increasing the child tax credit and eliminating the alternative minimum tax, which was intended to ensure that high-earners pay at least some tax.

The Fort Worth Business Press spoke with **Stephen J. Lusch, assistant professor of accounting at Texas Christian University**, about the bill's potential impact on business and North Texas.

FWBP: What are the key changes in the bill that will impact business?

LUSCH: "First, both bills propose a reduction in the corporate tax rate from 35 percent to 20 percent. These are the rates for entities that are organized as C Corporations. One difference between the House and Senate bill here is that this rate reduction is effective in 2018 for the House bill, but it not effective until 2019 in the Senate bill.

Businesses that are organized as pass-through entities will also potentially see a reduction in tax burden. Income generated from a pass-through entity (e.g., sole proprietorship, partnership, S-Corp, etc.) is distributed to its owners and taxed on their individual tax returns.

Under current law, this income is taxed at a maximum of 39.6 percent (i.e., the top individual ordinary income rate). Under the House bill, the proposal is that this pass-through income will be taxed at a maximum rate of 25 percent.

This comes with a few caveats.

For pass-through income generated from an activity in which the investor materially participates, 30 percent of that income will be subject to the 25 percent rate, while the remaining 70 percent would still be subject to a maximum rate of 39.6 percent. The reasoning here is that, for a material participant, 70 percent of distributions from a pass-through entity should be treated analogous to wages and thus should be taxed at the ordinary rate.

Lastly, no pass-through income from service businesses would be taxed at the new 25 percent rate; it would all subject to the maximum ordinary rate of 39.6 percent.

The Senate bill takes a different approach by allowing individuals receiving pass-through income to take a deduction for 23 percent of their 'qualified business income.' For higher income taxpayers, this deduction is limited to 50 percent of the total wages paid by the pass-through entity and, as with the House bill, is not available for owners of certain service businesses.

A big difference between the House and Senate bills is that the pass-through provisions in the Senate bill revert back to current law after 2025.

Second, both the House and Senate bills propose changes to cost recovery for asset purchases.

In general, when assets are purchased by a company they are capitalized, and thus not immediately expensed. Costs are then recovered over the life of the asset through depreciation deductions. … Under both the House and Senate bill, the bonus depreciation rate would be increased to 100 percent for five years (i.e., until 2023).

This, in essence, would result in what's called full expensing, meaning that the taxpayer is able to deduct the full cost of the asset in the year that it is placed into service. This accelerates the tax benefits of the depreciation deduction and thus reduces the after-tax cost of acquiring assets.

In the House bill the 100 percent Bonus Depreciation rate expires in 2023. In the Senate bill, it is phased-out by 20 percent per year starting in 2023. Both the House and Senate bill also propose changes to Section 179. The maximum allowable Section 179 deduction under current law is $500,000. The House bill proposes raising this to $5 million and the Senate bill proposes raising this to $1 million.

Third, both the House and Senate bill propose a shift from a worldwide tax system for corporations to a territorial tax system. The U.S. is the only developed nation that employs a worldwide tax system.

What that means is that a corporation domiciled in the U.S. is subject to U.S. federal corporate income tax on both its domestic as well as its foreign-source earnings. To avoid double-taxation, the current system provides for a foreign tax credit to offset taxes paid on the foreign-source income in other countries.

In addition, U.S. companies can defer the payment of U.S. federal corporate income tax on the foreign-source earnings by not repatriating those earnings from the foreign subsidiary back to the U.S. parent company.

The opportunity for deferral has resulted in a number of companies stockpiling foreign earnings overseas instead of repatriating those earnings back to the U.S. parent; this is referred to as the 'lockout effect,' and it acts as a barrier to the mobility of capital throughout a multinational corporation.

In both bills, the switch from a worldwide to a territorial system is coupled with a one-time tax on all unrepatriated foreign earnings. The proposed rates for this one-time tax is 7 percent (House) and 7.5 percent (Senate) for illiquid assets and 14 percent (House) and 14.5 percent (Senate) for liquid assets.

Finally, since a territorial system provides an increased incentive for shifting profits out of the U.S. as foreign-source income is no longer subject to U.S. corporate income tax, both bills provide a number of provisions to limit the use of intercompany transactions to shift income out of the U.S."

FWBP: What will be the impact of the changes to the corporate tax rate?

LUSCH: "It's difficult to say with certainty. One thing we know is that reducing the corporate income tax rate from 35 percent to 20 percent will reduce taxes paid and thus free up some cash. The question is how will that cash be used?

Economists have long observed that the incidence of the corporate income tax does not fall on the corporation itself, but instead falls on some combination of labor, customers and owners. The disagreement arises over the proportion of incidence borne by each group.

Thus, when corporate taxes are reduced, the expectation is that the tax savings should accrue to labor (e.g., through higher wages), customers (e.g., through lower prices), or owners (e.g.,

through reinvesting internally in new projects or returning the savings to owners through dividends).

This is where the argument for trickle-down effects of tax cuts arises from.

The argument would be that, for example, if the savings accrue to labor that their wages will be increased providing these laborers with additional cash flow to spend in the economy. Likewise, if the savings accrue to owners through higher dividends, then owners will have additional cash flow to spend in the economy, etc.

While, theoretically, there are sound arguments for simulative effects of corporate tax cuts, it all comes down to a question of magnitude. Will the economic growth resulting from the corporate tax cut offset the reduction in corporate tax revenue?

Thus far, I have not seen a score of either the House or Senate bill (as a whole, not just the corporate rate component) that suggests that the projected economic growth provided by the bill will offset its costs.

FWBP: How will small businesses be impacted? I believe there is a payroll tax cut for small business employers, will that help those businesses hire new employees?"

LUSCH: "Most small businesses are organized as pass-through entities, so the provisions discussed above that reduce the effective rates on pass-through income would apply to those businesses. In addition, as discussed above, the limit for immediate expensing under Section 179 is proposed to increase from $500,000 to $5,000,000 (House bill) / $1,000,000 (Senate bill). I have been through the full-text of both the House and Senate bills, and to the best of my knowledge there are no provisions in the bill related to payroll taxes."

FWBP: What's the impact on the housing industry? Are there changes to the home mortgage deduction?

LUSCH: "Both the House and Senate bill propose changes to the home mortgage deduction.

Under current law, taxpayers are able to deduct interest related to a maximum of $1.1 million of debt ($1 million of acquisition indebtedness and $100,000 home equity). In addition, this total of $1.1 million of debt can be attributable to up to two residences: the taxpayer's principal residence plus one other.

The House bill proposes reducing the allowable mortgage interest deduction to the interest paid on up to $500,000 of debt; in addition, this can only be attributable to the taxpayer's principal residence.

The Senate bill's proposed change is much smaller. It would still allow a deduction on up to $1 million of acquisition indebtedness, but would not allow any interest from home equity loans to be deducted.

And as discussed above, both bills proposed limitations to the deductible of real property taxes.

Thus, under the House bill in particular, a taxpayer who buys a home with a mortgage in excess of $500,000 would not be able to fully deduct all of the mortgage interest.

Likewise, a property of that value would have real property taxes in excess of $10,000 and thus the taxpayer would end up not being able to deduct all of the real property taxes either.

Having said that, under 5 percent of new mortgages in Tarrant County are over $500,000. So overall, this limitation impacts a minority of taxpayers. However, if property values continue to rise at the rates we've seen over the past few years, then more and more mortgages each year will be over $500,000.

In terms of effect, there may be shifts in the market equilibrium for higher priced homes.

Limiting the deductibility of home mortgage interest on higher priced homes increases the after-tax cost of purchasing that home. The magnitude of the expected effects though is difficult to estimate because it will depend on the price elasticity of demand.

Basically, are home buyers of these higher price homes very price sensitive, or not? The more price sensitive they are, the more that an increase in the after-tax cost of purchasing the home will influence demand.

In addition, since the House bill proposes limiting the deductibility of interest to debt associated with only the taxpayer's principal residence, the effect on the housing market in areas that largely consist of second homes (i.e., lake property, etc.) would likely be impacted to a larger degree."