# 2019-20 Tax Updates

EVC Board Meeting

November 20, 2019

## FEDERAL TAX

**1)** The Tax Cuts and Jobs Act passed in December of 2017 dramatically changed the federal tax landscape.

**2)** Notable changes enacted by the Tax Cuts and Jobs Act includes the following:

a) Corporate income tax is now a flat rate of 21%.

b) The top marginal income tax rate for individuals, estates, and trusts is reduced from 39.6% to 37.0%

c) A new Qualified Business Income ("QBI") deduction was introduced for business owners.

i) Effective for tax years beginning after December 31, 2017 and before January 1, 2026, individuals, as well as some trusts and estates, can claim a deduction equal to the taxpayer's combined business income (subject to certain limitations).

ii) Combined business income includes two components:

(1) 20% of the QBI from a business operated as a sole proprietorship or through a partnership, S corporation, estate, or trust.

(2) 20% of the aggregate qualified real estate investment trust (REIT) dividends and publicly traded partnership (PTP) income.

d) 100% accelerated bonus depreciation is available for new and used assets used in a business.

e) The applicable exclusion amount for estate and gift tax purposes was adjusted from $5 million (2017) to $11.4 million in 2019.

f) As we are approaching an election year, the federal tax landscape may change dramatically again if a new President is elected. Following please find a summary of the major components of the 2020 Democratic Presidential campaign tax proposals.

i) <u>Elizabeth Warren</u>

(1) Medicare-for-all plan that would provide a new government-run health care program in which all Americans are covered. Estimated 10-year cost is $34 trillion (as published by the Urban Institute).

(2) Includes a new Employer Medicare Contribution, which will require American companies with 50 or more employees to pay a contribution to the federal government in place of making premium payments to private insurers.

(3) Eliminate accelerated depreciation, including the 100% bonus depreciation currently available for assets used in a business.

(4) Raise the corporate income tax rate to 35% from the current rate of 21%.

(5) A new country-by-country minimum tax, that would require companies to remit the difference between the tax paid to foreign countries and 35% to the United States.

(6) New wealth tax of 2% on net wealth above $50 million and 6% on net wealth above $1 billion.

(7) Eliminate the preferential tax rates on long-term capital gains and qualified dividends for the top 1% of households and apply ordinary income tax rates.

(8) New financial transactions tax that will impose a tax of 0.1% of the value of stocks, bonds, derivatives, and other debt obligations purchased.

(9) Implement a new "mark-to-market" tax system on capital gains for the top 1% of households, where capital gains (excluding retirement accounts) will be taxed annually instead of only when the asset is sold or transferred.

(10) An additional 14.8% tax on “net investment income” for taxpayers with income in excess of $250,000 for an individual and $400,000 for a married couple.

(11) A new payroll tax of 14.8% on earnings above $250,000 to be split between the employee and the employer.

(12) Eliminate the income tax deductions for medical expenses and contributions to health savings accounts and medical savings accounts.

(13) Any amounts paid towards health insurance (including the new medicare for all plans) will no longer be eligible for a pre-tax deduction from taxable wages._As a result, individuals will be taxed on the income used to pay for health insurance costs. This includes both income and payroll taxes.

(14) No formal proposal from Warren regarding estate tax; however, Warren expressed her desire to make death a" realization event", meaning that any appreciation in assets upon expiration would be subject to tax.

ii) Joe Biden

(1) Revert the current top ordinary income tax rate back to 39.6% from the current rate of 37%.

(2) Long-term capital gains and qualified dividends will be taxed at the top rate of 39.6% for taxpayers earning more than $1 million. The current federal income tax rate available for long-term capital gains is 20%.

(3) Remove the current cap on the Social Security payroll tax, meaning an employee and employer would each pay 7.65% (6.2% Social Security and 1.45% Medicare) on all wages. Currently, Social Security is assessed on wages up to $132,900.

(4) Raise the corporate income tax rate to 28% from the current rate of 21%.

(5) Eliminate the stepped up basis upon death.

iii) Bernie Sanders

(1) Update the current income tax brackets by retaining the bottom six brackets and adding four more.

(a) The 35% rate under current law would become 40%.

(b) Additional rates of 45%, 50%, and 66% will be introduced.

(c) The 66% rate will apply to income over $10 million.

(d) Introduce a new 4% income-based premium at each level of the income tax bracket above $29,000.

(2) Long-term capital gains and qualified dividends will be taxed at ordinary income tax rates for those earning $250,000 or more.

(3) Require employers and employees to split the 12.4% Social Security and Medicare tax again once earnings exceed $250,000.

(4) New 7.5% payroll tax on employers. The first $2 million in wages paid would be exempt from the tax.

(5) Cap the maximum benefit of itemized deductions at 28%.

(6) Subject all S corporation income to self-employment tax. Currently, only the taxable wages paid to the shareholders performing services for the S corporation are subject to self-employment tax. This will include distributions of profit made to the shareholders that currently escapes self-employment tax.

(7) Estate tax would be modified as follows:

(a) 45% tax on assets valued between $3.5 million and $10 million

(b) 50% tax on assets valued between $10 million and $50 million

(c) 55% tax on assets valued between $50 million and $1 billion

(d) 77% tax on assets in excess of $1 billion

(8) Eliminate the stepped up basis upon death.

(9) Raise the corporate income tax rate to 35% from the current rate of 21%.

iv) Kamala Harris

(1) Update the current income tax brackets similar to the proposal from Bernie Sanders outlined above, with one exception: the 4% income based premium would not apply for those with income under $100,000.

(2) Harris embraces Sanders' plan to apply ordinary income tax rates to long-term capital gains and qualified dividends for those earning $250,000 or more.

(3) Cap the maximum benefit of itemized deductions at 28%.

(4) Harris embraces Sanders' plan to modify the estate tax as outlined above.

(5) Eliminate the stepped up basis upon death.

v) Andrew Yang

(1) A new 10% value-added tax (VAT) on every product sold in the United States.

(2) Provide each American adult $1,000 per month in universal basic income, what he calls a "Freedom Dividend".

(3) Tax capital gains and carried interest at ordinary income tax rates.

(4) Introduce a tax on financial transactions.

(5) Remove the current cap on the Social Security payroll tax, meaning an employee and employer would each pay 7.65% (6.2% Social Security and 1.45% Medicare) on all wages. Currently, Social Security is assessed on wages up to $132,900.

# CALIFORNIA TAX

**1) California AB-5 will take effect on January 1, 2020.**

a) AB-5 codified the 2018 decision reached in *Dynamex Operations West, Inc. v. The Superior Court of Los Angeles County* that requires an employer to use a new ABC test to determine if a worker should be designated as an employee or an independent contractor under the California Wage Orders.

i) A worker is presumed to be an independent contractor if all three elements of the ABC Test are satisfied.

(1) Part A: The worker is free from the control and direction of the hirer in connection with the performance of the work, both under contract and in fact.

(2) Part B: The worker performs work that is outside the usual course of the hiring entity's business.

(3) Part C: The worker is customarily engaged in an independently established trade, occupation or business of the same nature as that involved in the work performed.

ii) The ABC Test narrows the definition of an independent contractor, and as a result, most service providers will now be classified as employees.

**2) California Senate Bill (SB) 378 will NOT be reinstated into the California Legislature and will NOT be appearing on the 2020 ballot.**

a) SB 378 proposed a 40% California tax on estates, gift and generation-skipping transfers made by California residents beginning January 1, 2021.

b) It included a significantly lower applicable exclusion amount of $3.5 million (compared to $11.4 million currently in effect for 2019 for federal purposes).

c) However, the bill failed to receive a floor vote and will not be reinstated into the California Legislature.

d) However, similar proposals could be reintroduced in the next legislative session.

**3) "Split Roll" initiative on property taxes is qualified to be on the November 3, 2020 ballot.**

a) As of 2019, Proposition 13 (1978) requires the taxable value of residential, commercial, and industrial properties to be based on 1% of the property's purchase price, with an annual adjustment equal to the rate of inflation or 2%, whichever is lower.

b) "Spilt Roll" initiative would amend the state constitution to require commercial and industrial properties, except those zoned as commercial agriculture, to be taxed based on their market value effective January 1, 2022.

c) The "Split Roll" initiative provides the following tax exemptions:

i) The first $500,000 of a business's personal property or

ii) 10% of a business's personal property when the business has 50 or fewer full-time employees.

iii) Continue to tax properties of businesses whose holdings in the state are valued at less than $3 million based on their purchase price, rather than market value.

d) "Split Roll" initiative is likely to have a significant impact on the cost of doing business in California.

**4) Sales Tax Nexus**

**a) Multi-state businesses are subject to state sales tax when nexus is established.**

i) Each state defines nexus for sales tax purposes differently.

ii) However, precedent established by rulings from the Supreme Court define guidelines for states to follow when determining their nexus requirements.

iii) For sales tax purposes, the following historic rulings have defined the state sales tax landscape.

(1) In 1992, *Quill Corporation v. North Dakota* ("Quill") established the precedent that a business must have a physical presence within the state in order to become subject to the state's tax.

(2) In 2018, that ruling was overturned in *South Dakota v. Wayfair, Inc.* ("Wayfair").

(3) The Supreme Court overturned the physical presence requirement established in Quill and introduced an economic nexus standard based on the level of sales or number of transactions.

iv) An increasing number of states are now modifying their nexus requirements for sales tax purposes and migrating away from physical presence and to economic, affiliate, and market based facilitator nexus standards.

v) The landmark ruling reached in Wayfair that removes the physical presence requirement to establish nexus also impacts businesses that operate solely within California.

vi) California businesses are also subject to district taxes that are assessed by the various districts (cities and counties) throughout California.

(1) The district tax rates range from 0.10% to 1.00%.

(2) Districts are now beginning to employ an economic nexus standard.

(3) As a result, more and more businesses may find they are subject to district taxes within cities and counties in which they have no physical presence.

## FOREIGN TAX

**a) IRC §965 Transition Tax on Accumulated Foreign Earnings**

a. As part of the transition to this partial territorial system of taxation, IRC §965 imposes a one-time toll charge on a U.S. shareholder's pro rata share of untaxed foreign earnings that have accumulated in specified foreign corporations.

b. For tax years beginning after December 31, 2017, a U.S. shareholder that is a domestic corporation can deduct 100% of the foreign-source portion of dividends that it receives from a foreign subsidiary, which eliminates U.S. tax on that income. Individuals are not eligible to exclude foreign source dividends.

c. This is a one-time event. Taxpayers can elect to pay the toll charge in eight annual installments.

**b) Domestic Corporations are subject to U.S. tax on their global intangible low-taxed income (GILTI).**

a. Global Intangible Low-taxed Income (GILTI)

i. As a part of the 2017 tax reform legislation, Congress introduced IRC §951A, which requires U.S. shareholders of a controlled foreign corporation ("CFC") to include in gross income their share of the GILTI earned through one or more CFCs for tax years after December 31, 2017.

ii. The term "GILTI" generally refers to the excess of a CFC's business income, net of allocable expenses, over a notional 10% return on the CFC's depreciable personal property.

iii. As a result, despite its name, GILTI is computed without regard to the relative character of the CFC's income, or whether the income is, in fact, low-taxed income.

iv. The GILTI provisions most severely impact U.S. companies with foreign earnings but insubstantial fixed asset bases relative to their income, regardless of whether the income is derived from the use of actual intangible property.

1. A U.S. person that owns at least a 10% stock interest in the CFC is subject to the GILTI provisions.

v. Domestic C corporations are allowed a deduction for 37.5% of its foreign-derived intangible income ("FDII") and 50% of its GILTI that is included in gross income.

1. The 50% deduction of the GILTI inclusion results in an effective tax rate of 10.5% on GILTI.
2. Individuals are not eligible for these deductions. As a result, GILTI is taxed at the individual's ordinary income tax rates. This can be as high as 43.4% if you are in the top marginal income tax rate of 39.6% and the net investment income tax of 3.8% applies.

vi. The FDII deduction is computed separate from the GILTI inclusion.

vii. Similar to GILTI, a corporation's FDII is not determined by tracing or attributing income to the exploitation of intangible property.

1. Rather, FDII is computed by applying a fixed rate of return to its deemed intangible income.

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