# National Small Business Network

# TCJA Correction Priorities

## Policy Recommendations for the 116th Congress – November 2019

In 2017 Congress passed the Tax Cuts and Jobs Act (TCJA), P.L. 115-97 which included many major tax policy changes. We believe the legislation did not achieve the objectives of good revenue neutral tax reform and needlessly added to the federal deficit, with potential long-term economic consequences. The legislation contained provisions which were inconsistent, inequitable, needlessly complex, and economically unsustainable.

**Deficit financed tax cuts at a time of strong economic growth were not the solution for a sustainable economy.** The GAO and CBO have concluded "The federal government is on an unsustainable fiscal path" with spending exceeding revenue by $782 Billion in fiscal 2018, with the projected debt growing to 100% of total GDP in just 12 years. Since last year's deficit was 3.9% of GDP, most of our GDP growth is actually artificial and just the result of increased debt pushed onto future generations. Most economists believe that continuing deficits adding to our now $22 Trillion national debt will reduce long-term economic growth, and are a very real threat to the future sustainability of our economy. We agree with the CBO and GAO recommendations, and those of other fiscal policy advisory groups. The TCJA tax rate cuts, combined with territorial based taxation of multi-national corporations, which encourages profit shifting to lower tax countries, will continue to reduce tax revenues needed to balance expenditures.

**Unfortunately, tax cuts are easier to give, than to take away, particularly in today's ultra-partisan political environment.** The best solution for the long-term economy and federal revenue would probably be to repeal the TCJA and start over, but that is not realistic. We suggest instead a bi-partisan effort to correct the worst elements of the TCJA combined with an incremental approach to raising additional revenue through strategic tax reform.

The following recommendations for corrections to the TCJA, are suggested as part of a balanced program of both tax increases and budget reductions to restore a sustainable Federal fiscal process. They focus primarily on business tax reform issues, particularly for small and mid-sized businesses, because those will have the greatest impact on job creation and general economic growth.

**A. Correct the drafting error in depreciation provisions on Qualified Improvement Property (QIP) which accidentally eliminated the provision for lease holds, restaurants and retailers to depreciate non-structural improvements over 15 years rather than 39 years.** This more realistic 15-year depreciation period for periodic renovations is very important to the success of small businesses and should be restored. The correction should allow the taxpayer to either amend prior returns or update the changes on their next return. There has been strong bipartisan support for correcting this un-intended drafting error.

**B. Correct the un-intended imposition of a 40% higher tax increase on small start-up C corporations by reinstating graduated small corporation tax rates.** Congress has always said that they understand the critical importance of small innovative businesses to the economy, yet the TCJA eliminated the graduated rates on small C corporations and actually increased the tax rate on small startups by 40% by deleting the lower 15% tax bracket on the first $50,000 of income. Most high growth potential start-ups, who may become the base of future economic growth, are organized as C corporations because of the need to attract equity capital. Based on 2013 IRS statistics, the most current numbers available, approximately 556,400 small business are in this category and have had their taxes increased by the

JCTA. We recommend legislation to reinstate the lower 15% tax rate on C corporation income below $50,000 and provide graduated rates between $50,000 and $10 M of corporation taxable income.

**C. Increase the $10,000 TCJA limitation on the deduction of State and Local Taxes (SALT) to at least include state taxes on pass-through business income.**

The limitation, which was originally justified as an offset to the increased standard **personal** deduction, is particularly punishing to small business owners. Most small businesses are pass-through entities and pay state and local income taxes on the amount of their business income on their personal state tax return. This is in addition to all the other taxes on their wage income, investment income and property taxes on their home. This probably makes much of the state income tax on their business income, which is as high as 10% in some states, non-deductible because of the $10,000 limit. C-Corporations, in contrast, are able to fully deduct state and local business income taxes and other taxes at the business level.

The inability to equitably deduct state income taxes on business related income is also counter to the established Congressional policy of providing equity of deductibility for either state income or sales taxes. State sales taxes paid by businesses in sales tax states will remain fully deductible in any amount at the business level because they are part of business purchase costs, but state Income taxes paid on business income will probably not be deductible. We recommend that small business owners be allowed to deduct state and local income taxes paid on their pass-through business income, as defined by section 199A, in addition to the personal tax deduction cap.

We also believe the new low limitation on the overall deductibility of State and Local taxes should be reconsidered. It makes it more difficult to pass funding measures for better education systems, and for cities and states to fund better public safety and infrastructure. These are serious problem areas where the federal government provides little funding or support. Local citizens should be incentivized to solve them without having to pay a “tax on a tax” for income they never actually received. We believe the SALT deduction limit for all individual taxpayers should be raised to at least $50,000 to reduce the disincentive on taxpayers to support higher state and local taxes to solve problems the federal government is ignoring.

**D. Remove the Specified Service Industry exclusions from the Section 199(A) 20% adjustment on pass-through Qualified Business Income (QBI). Replace them with a better universal criterion for separating personal labor earnings, which should be taxed as wages, from true business income resulting from capital assets and employee labor.**

Section 199A of the TCJA, was intended to create rate equity for pass-through businesses but unfortunately also created a large amount of complexity, uncertainty, and inequity for the 98% of businesses organized as pass-throughs. One of the most inequitable provisions was the exclusion or phaseout of income from certain designated business sectors from the 20% reduction on Qualified Business Income for taxpayers if the taxpayer is over a $157,000/$315,000 total income limit. The designated business sector exclusions selected were inappropriate carry-overs from prior code provisions for special tax incentives, including Sec. 1202 small business investment incentives, the old Sect. 199 manufacturing – exporting incentives, and the relief provisions from the 3.8% Net Investment Income tax for active businessowners.

Section 199A, however, was not intended as a special incentive, but was simply proposed as way to provide some equitable rate reduction for pass-through businesses to balance the rate reduction the bill made in corporation taxes. It was in fact originally proposed as just a lower tax rate on pass-through business income before House staff developed the Sec. 199A concept.

It is important that the tax code differentiate between reasonable wages for personal services performed by business owners and true business income, but there is no logical basis for excluding all income from business sectors such as health care, accounting, and financial services from the lower rate given all other businesses. Ironically, because the TCJA adjustment exclusion only applies to taxpayers over the income thresholds, it is the larger businesses in these sectors, who probably have much higher levels of true

business income from capital assets and employee labor, that are unfairly excluded from the adjustment. The higher corporate tax rate for "Personal Service Income" from these sectors was also eliminated by the TCJA, which makes these categorical exclusions for pass-through businesses even more inequitable. The Congress needs, instead, to define a broader test for true business income, similar to the wage-asset requirements for other business sectors, to provide better tax equitability for all business sectors. Because of the increased complexity and added preparer penalties of 199A, a clearer set of criteria for "Reasonable Compensation" for personal services by owners of a business should also be developed to assure that personal service income is properly identified and taxed as wages for employment and income taxes.

**E. Add "Guaranteed Payments" made to partners to the definition of wages for the Sec. 199(A) wage-asset test.** The TCJA taxable income adjustment should apply equitably to all pass-through business entity types. The use of the term "W2 wages" for the wage-asset test of QBI discriminates against partnership partners who receive their compensation as "guaranteed payments" which are subject to self-employment taxes, but not considered "W2 wages" by the code. Congress should add guaranteed partnership payments and other wage equivalents to any wage-asset based test of QBI.

**F. Repeal the complex and unreasonable parking area provision that resulted in non-profits having unrelated business income and for-profits having non-deductible expenses.** Section 512(a)(7) of the TCJA required non-profit organizations to recognize the "value" of employee parking areas as "unrelated business taxable income", and also removed the deductibility of the value of owned or leased areas used for private business employee parking. Trying to accurately value something as variable and diverse as space used for parking, particularly mixed-use parking, is very complex. The initial IRS guidelines for determining valuations are ridiculously burdensome and will probably be ignored by many taxpayers. The potential administrative burden on taxpayers, and potential IRS compliance expense, will probably exceed the minor amount of additional revenue collected.

Available worker parking is a basic facility cost that benefits the employer, not a non-deductible personal auto commuting expense, such as providing a company car. Land development codes in most cities require specified amounts of customer and employee parking, or compensating parking fees, for any commercial construction. However, the value of parking areas, either customers or employees, is seldom broken out in leases or property valuations because it is really a requirement for the business to be able to use the property. It is also inequitable to prevent deduction of this expense for employers in higher density areas who must provide it to compete for workers, because businesses in low density areas can have their employees park on public streets paid for with fully deductible property taxes. This is particularly true for businesses such as real estate where employees must use personal cars regularly during the day to work and require quick access. Employee parking is just as valid a business expense as the office in which an employee works, or a coat room where they hang their coat, or a break room where they eat lunch. With the low IRS proposed threshold of $1000, calculation of this complex provision will impact hundreds of thousands of small non-profits, and millions of businesses. If having an employee parking space available is now to be treated as a commuting fringe benefit, then all "employees", including federal, state, and local government employees, military members, as well as nonprofit and private employees should have the value of this "benefit" reported or their W2 as taxable income. Instead, we believe this provision of the TCJA should be repealed retroactive to 2017.

**G. Re-instate the personal deduction for employee business expenses, which was eliminated by the TCJA.** With changes in technology and the workforce, more employees are working outside of a conventional business location and are being required by employers to fund more of their own expenses for equipment, technology, transportation and even work space. Since these required costs reduce their effective income, they should be deductible against their wage income as would be allowed for a self-employed independent contractor.

**H. Better define when rental real estate investment rises to a trade or business.** While Section 199A allows Real Estate Investment Trusts to be eligible for the 20% income deduction, it is unclear when

an owner of rental property is eligible. The Internal Revenue Service issued Notice 2019-7 on January 19th, but unfortunately, it provides an unworkable safe harbor that fails to consider the diversity of type, size and age of rental properties. The safe harbor requires the owner, an employee, agents or independent contractors to totally perform 250 hours of rental services in the year to qualify. In addition, it requires contemporaneous records, including logs or similar documents to be maintained. This is an unreasonable burden on smaller rental property owners.

Congress should pass legislation specifying reasonable requirements for when a rental property qualifies. A more reasonable number of qualifying hours would be 100. Estimates should be allowed for time performed by agents and independent contractors. In addition, all time spent by owners or agents on relevant business activity, including administrative work, financial activity, and necessary business travel to the property, and managing financing should be included for the 100-hour requirement.

**I. Section 199A carryover rules also need to be revised.** Under the final regulations, taxpayers must calculate and keep track of possibly four distinct carryforward amounts. These calculations are complex and even the most tax knowledgeable taxpayers will find them impossible to understand. The current regulations become even more complex when taxpayers attempt to aggregate different businesses. Congress should repeal or simplify these carryforward loss rules.

## Possible offsetting revenue raisers:

- **Phase-out Bonus Depreciation more quickly.** Although accelerated expensing can be a useful economic tool during a recession, its use at the peak of an economic cycle was not needed. It increased the annual federal deficit and growth of the national debt, which will have future negative economic consequences. Even more importantly, when the next recession happens, the Congress will have few practical tax incentives left for stimulating the economy when needed. The Federal Reserve, which has been massively stimulating the economy for the last 10 years, with very low interest rates and monetary expansion, is also still in a weak position to provide emergency stimulus when another major recession occurs. There are already signs that the next recession is not far away.
- **Do not reauthorize the expired tax-expenditure "extenders" without clear evidence of their actual broad economic value and true need.**
- **Do not vote to exceed the existing budget sequestration caps**. Reduce less needed programs.
- **Increase the holding period to qualify for the long-term capital gains rate to 3 years.** This would have the added benefit of encouraging longer term capital investments in businesses and buildings, rather than speculation in traded securities which creates no economic growth.
- **Fund needed transportation infrastructure improvements now with inflation updated usage-based fuel taxes and fees rather than general tax revenues.**
- **Change the taxation of multi-national corporations to a worldwide formulary allocation system based on their percentage of sales in the US.** This will reduce shifting of profits on US sales to low tax countries through accounting games.
- **Increase corporation tax rates, at least by 2026 when the TCJA individual rate reductions end, and adopt lower progressive rate brackets for small corporations.**
- **Stabilize the Social Security System by increasing the contribution wage cap, increasing the retirement ages, and reducing benefits for higher income retirees.** Although not yet a discretionary expenditure, if the Social Security and Medicare entitlement systems are not quickly reformed, they will eventually require general fund expenditures.

See our more complete Tax Reform and Fiscal Policy Recommendations on our website at www.NationalSmallBusiness.net.

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