National Small Business Network

TCJA Correction Priorities

Policy Recommendations for the 117th Congress – February 2021

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 previously concluded "The federal government is on an unsustainable fiscal path" with spending exceeding revenue. CBO projects that the annual deficit will exceed at least $1T in each of the next 10nyears with the debit reaching107% of GDP in two years, and 195% of GDP by 2050 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 $25.8 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 government 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 may not be realistic. We suggest instead a bi-partisan effort to correct the worst elements of the TCJA combined with an incremental approach toward raising additional revenue through strategic tax reform as much as is possible under the current economic conditions. These recommendations 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. They are particularly needed as a result of the dramatic Pandemic impacts on small businesses and their workers.

A. Re-instate the personal deduction for employee business expenses, which was eliminated by the TCJA. The Covid-19 pandemic has rapidly accelerated changes in business processes and the workforce that will probably persist even after the current emergency ends. By governmental mandates and employer policy changes, more employees are working from home, or outside their conventional business location. They are often being required by employers to fund many of their own expenses for work space, technology equipment, business supplies, transportation and even personal protective equipment. Many former contractors for companies like Uber and Lyft are being reclassified by states as employees, but with no changes in their expense reimbursement agreements. To avoid exposing their families to the virus, many front-line health care workers are even having to rent hotel rooms or alternative living places. Since all these required expenses reduce an employee's effective income, they should be deductible against their wage income as would be allowed for an independent contractor.

B. Correct the un-intended imposition of a 40% higher tax increase on small start-up C corporations by re-instating 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, 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 SALT deduction 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 full 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. The flat $10,000 cap on state and local taxes probably makes much of the state income tax on their business income, which is as high as 10% in some states, non-deductible. C corporations, however, 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. Sales taxes paid by businesses in sales tax states 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 in high income tax states 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 for 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 199A 20% adjustment on pass-through Qualified Business Income (QBI). Replace them with a better universal criterion and reasonable limits 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, if the taxpayer has over $157,000/$315,000 total income. 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. 199A 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 TCJA 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. 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.

G. 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.

H. Repeal the complex and unreasonable "parking space tax" provision that changed a necessary business expense to a taxable transportation fringe benefit for employees 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 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 both customer and employee parking, or compensating parking fees, for any commercial construction. The value of parking areas, either customers or employees, is seldom even

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. The need for on-site parking is particularly true for businesses such as real estate agencies 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 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 simply be repealed retroactive to 2017.

Possible offsetting revenue raisers: For the past 25 years, we, along with others, have been advocating for sustainable Federal Fiscal policies. Unfortunately, the Covid-19 economic crisis has now happened with no easy recovery options available. If more sustainable fiscal actions had been taken prior to the recession they could have provided more powerful tools for economic recovery, and they are still needed.

- **Increase corporation tax rates, at least by 2026 when the TCJA individual rate reductions end, and re-adopt lower progressive rate brackets for small C corporations.**

- **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.

- **Phase-out Bonus Depreciation or immediate expensing for larger capital assets.** 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, now that the next recession is here, the Congress has lost this easy tax incentive for stimulating the economy when needed.

- **Do not reauthorize tax-expenditures without clear evidence of their actual broad economic value and need.**

- **Do not vote to exceed existing adopted budget caps**. Reduce less needed programs. (this option was eliminated by the Covid crisis and need for economic stimulation)

- **Increase the holding period to qualify for the long-term capital gains rate to 2 years, and allow it only for direct investments in a business, property or other economic asset, not on traded securities. Index the rate for inflation after 5 years.** This would encourage longer term capital investments in businesses and buildings, rather than speculation in traded securities which creates no added economic growth.

- **Fund needed transportation infrastructure improvements now with inflation adjusted usage-based fuel taxes and fees rather than general fund revenue debt.**

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