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"Only the State obtains its revenue by coercion…That coercion is known as 'taxation,' although in less regularized epochs it was often known as 'tribute.' Taxation is theft, purely and simply even though it is theft on a grand and colossal scale which no acknowledged criminals could hope to match. It is a compulsory seizure of the property of the State's inhabitants, or subjects."

— Murray Rothbard

Tax and Financial Strategies

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Wealth Creation Strategies

A Critique of the Tax Cuts and Jobs Act (TCJA), with Recommendations for Future Acts

Barring the elimination of the 16th Amendment, which created the "graduated" tax on productivity (which, if our goal is greater overall societal wealth, was the most catastrophic mistake ever in amending the Constitution), many improvements could be made to the TCJA. Here are some ideas for real reform and simplification. The first two are generic and would go furthest in simplifying tax law; those following the first two are specific recommendations, intermingled with pros, cons and analyses of various parts of the law.

Further decrease maximum tax rates

Maximum tax rates should be decreased much more than was done, so that more earnings are left in the hands of those who have proven they save, invest and spend it wisely. Because private citizens do so more than any government can or ever will, massive increases in wealth occur with lower tax rates (assuming rule of law, protection of private property and enforcement of contractual rights, which are essential to the creation of proper incentives).

Eliminate phase-outs and phase-ins of credits, deductions and income

Eliminate ALL phase-outs of credits or deductions and ALL phase-ins of income. "Equality" under the law requires that all taxpayers, regardless of income, be treated the same. Either allow a deduction or credit, or don't—it shouldn't be taken away when income is above some arbitrary number. Either tax income, or don't—don't make more of something taxable over some arbitrary level of income.

The phase-out of the American Opportunity (tuition) Credit creates substantially higher (phantom) tax rates for those in the phase-out zone ($160,000 to $180,000 for joint filers; $80,000 to $90,000 for Single and Head of Household filers). The phase-out of the rental loss allowance (as Adjusted Gross Income increases from $100,000 to $150,000) creates hugely higher effective tax rates for those in that phase-out zone. The phase-in of Social Security to the taxable base (starting at $25,000 for Single and Head of Household filers and $32,000 for joint filers) creates monstrously higher real tax rates for retirees in the phase-in zone. These, along with numerous other phase-ins and phase-outs, create innumerable phantom (but very real) oddball exorbitant marginal tax rates. This results in enormous challenges for planning and decision making, especially when determining optimal pension/IRA contributions, pension/IRA withdrawals and Roth conversions. Eliminating these artificial phase-ins and phase-outs would vastly simplify tax law and planning. And because so many tax rates are hidden from view from the average taxpayer, eliminating these would make the tax system more "honest."

Make all out of pocket medical costs deductible via Health Savings Accounts (HSAs)

The first and foremost specific criticism from this libertarian's perspective involves the deductibility of medical costs. The current Congress nearly eliminated the deduction for medical expenses, but thankfully this awful idea was scrapped at the last minute from what became the Tax Cuts and Jobs Act. The gradual decreased deductibility of medical costs over decades has likely helped spur political demand for the third-party payer system that is, with Medicare front and center, the cause of increases in medical prices beyond all reason (when you don't pay directly, you don't look at prices, and many taxpayers seem to think that if they can't deduct it someone else should pay for it). The threshold that medical costs must exceed before becoming deductible increased from 1% of Adjusted Gross Income in 1954 to 3% by 1960, 5% in 1984, 7.5% in 1987

and 10% for most taxpayers in 2014. The TCJA decreased this to 7.5% for 2017 and 2018, after which it reverts to 10%.

A more rational approach would be to make all medical costs fully deductible via Health Savings Accounts (HSAs), allowing unlimited contributions up to the extent of current medical expenses plus an extra (as an example) $10,000 per year. Not requiring itemizing would allow those with little or no current medical costs to save tax-free for future medical costs, and at the same time decrease demand for politicians to take your earnings via taxes to pay for my care. In addition, we have a hunch the IRS could more efficiently police HSAs, with built-in protections, than it can a separate schedule of itemized deductions.

In addition, the cost of high-deductible (and only high-deductible) insurance should be fully deductible by individuals, not employers, which would make insurance portable. This would allow you to take it with you when you move from one employer to another, or to self-employment (which would slowly but surely eliminate the need to force insurers to cover pre-existing conditions, an artifact of the failure to allow portable insurance, which makes a mockery of "insurance"). An acceptable alternative would be to allow employers to include in compensation tax-free dollars intended for the purchase of the employee's choice of qualifying high-deductible health coverage directly from an insurance provider, with excess funds allocated to HSAs.

The pros and cons of limiting state and local income tax and property tax deductions to $10,000

The TCJA limits total state and local income tax *and* total property tax deductions to no more than $10,000 (with an option to deduct sales tax instead of state income tax), *regardless* of filing status. This means two single filers sharing expenses of a home can each deduct up to $10,000 of such taxes, double the allowable $10,000 maximum for a married couple. This was not only a huge mistake; it was ironic considering it was instituted by a Party that ostensibly supports marriage and family.

However, there are admittedly two excellent arguments for limiting such deductions (but without punishing marriage). First, it's an indirect subsidy for residents of higher-taxed (income and/or property tax) states, which is arguably unfair to denizens of lower-taxed ones. Second, if the states can't, in effect, share the cost of state "services" with the federal government, they might be forced (by angry residents) to reduce overall taxes and spending. After all, one of the advantages in the highest-taxed state of California for very high-income individuals (whose income exceeded the point at which the Alternative Minimum Tax limited the value of their deductions) was the 39.6% savings (the federal maximum tax rate) from the state income tax deduction. At the theoretical highest 13.3% marginal state rate, this effectively reduced their net state tax cost to about (39.6% x 13.3% = 5.3% tax savings; 13.3% - 5.3% =) 8%, for a total federal and state tax rate of less than 48%. Under the new regime, their total federal and state income tax rate increases to (37% + 13.3% =) 50.3%. Pundits who would have you believe high-income earners (often the most productive members of society) got off scot-free are lying.

However, there are two compelling opposing arguments.

First, the political demand for the federal government to pay costs that state and local governments should pay could increase. If state and local governments can't pass along their tax increases to the federal government in the form of deductions for state and local taxes, those governments may ask the federal government to do their job or stop offering services that were previously paid for with taxpayer money. As long as Trump is President, the feds are unlikely to give them extra money or help beyond what is already done; I'm concerned about this when a future Congress with a different majority regains power.

Second, rational and fair tax theory arguably suggests that taxes should not be imposed without an offsetting deduction for taxes paid to an underlying entity. The failure to allow such a deduction constitutes double-taxation. For example, if you pay 40% to the federal government and another 10% to a state or local government without benefit of a federal tax deduction, you're paying federal tax on the underlying state and local taxes, and your tax rate is 50%. A deduction for the state/local tax paid effectively means you pay 40% of the 90% left over, or 36%. Your combined tax rate is, then, (36% + 10% =) 46%. That seems a heck of a lot fairer (but since when did fairness have anything to do with theft?). If the maximum tax rate under the proposal was 15% (and fixed in stone), we wouldn't care so much. But with federal marginal rates as high as nearly 54% (the likely potential maximum marginal federal tax rate for those in the QBID phase-out zone), we care.

We've long suffered double-taxation of the 7.65% of "employee's" share of Social Security/Medicare taxes ("FICA" on your pay stub), which is half of the 15.3% Self-Employment tax for sole proprietors and active (non-rental property) partners. The employer's half is deductible by the employer on their business tax return; there is some equity in taxing the Social Security benefits represented by this half, on which neither you nor your employer paid tax. However, the "employee's" half was never deducted against taxable income; therefore, tax is paid on this half when it's subtracted from your paycheck. (For example, if your gross salary is $1,000, you pay tax on that $1,000, even though 7.65%, or $76.50 was withheld for FICA, comprising Social Security and Medicare tax. Therefore, you paid tax on the $76.50—and later in life you will pay tax on the Social Security received, arguably that same $76.50.) This is true, as well, of numerous other taxes, from sales taxes to fuel and utility taxes, including those on your cable bill. Once upon a time (pre-1964), to the extent

such taxes even existed, nearly all were deductible (and we still have clients asking about such deductions—long memories!). Congress has gradually reduced and then eliminated these deductions. Even the Tax Reform Act of 1986, which lowered the top rate to 28% in exchange for eliminating a host of deductions and tax shelters, didn't give us a permanently "low" maximum tax (it lasted all of three years). With the new TCJA, Congress imposes a 37% top advertised rate, plus 3.8% NIIT (the Net Investment Income Tax, an Obama "care" Medicare "surtax") and eliminates a host of deductions. The tax cuts aren't nearly large enough to encourage increased production, or even put us all on equal footing with the serfs of the middle ages.

The pros and cons of the new mortgage interest deduction restriction

The new law limits the mortgage interest deduction to interest on the first $750,000 of "acquisition indebtedness" on one's main home and a 2nd home for home purchases and home improvement debt incurred after December 15, 2017. "Acquisition debt" is, generally, the loan(s) taken when you purchase your home, plus new debt to pay for improvements, less principal pay-downs. Older loans and homes are mostly grandfathered and discussed below.

The deduction for interest on up to $100,000 of debt (or PARTS of such debt) used for any purpose other than to acquire or improve your main or 2nd home (considered "home equity" debt, or HELOC or "lines of credit", even if the additional debt is part of the main loan), is eliminated entirely (unless used for another "approved" purpose, such as to fund business, investment or rental property activities, but with limitations). The elimination of this deduction is retroactive.

Let's say, for example, you bought a home with a $400,000 mortgage. You paid it down to $340,000 and then refinanced for $400,000, using the $60,000 cash-out for non-home improvement purposes (such as a vacation, car or to pay off credit cards). The interest on your acquisition indebtedness of $340,000 (original debt minus the pay-down) is still deductible; the interest on the $60,000 "home equity" debt, which last year was deductible for regular tax purposes, is no longer deductible in 2018-on! This new restriction seems idiotic because, in our view, it will prove to be nearly unenforceable. We attempted to track and trace the use of funds because interest on loans used for other than acquiring or improving your home wasn't deductible for the purpose of calculating the Alternative Minimum Tax. However, because the interest on non-acquisition debt of $100,000 or less was rarely limited by the AMT and was, therefore, nearly always fully deductible, we didn't take great pains to be precise. On the other hand, due to the increased standard deduction, in many if not most cases it may not matter, since most previous itemizers will no longer itemize.

And what if you bought the property before December 16, 2017? Old acquisition debt up to $1 million (not "equity" debt in which the loan proceeds were used for anything other than home improvements) is grandfathered. You can also refinance old debt and continue to deduct the interest on up to $1 million in loans secured by homes and 2nd homes purchased prior to December 16, 2017. The deduction for previously deductible interest paid on loans from $1 million to $1.1 million is eliminated (interest on home mortgages exceeding $1.1 million hasn't been deductible since the Tax Reform Act of 1986).

You can still "trace" the use of the proceeds of loans secured against your home to business, rental or investment activities, whereby interest on loans used to fund those activities are deducted against that activity's income (but which may be limited). Funds from a secured loan on a rental property used to purchase your own home are considered personal use and the interest paid remains non-deductible.

The National Association of Realtors® was, of course, dead-set against the lower $750,000 limit, as they claim it will harm the housing market. When the Netherlands largely eliminated similar tax benefits for home purchases in 2012, home prices fell by about 10%; now, they are increasing. A libertarian view is that no sector should be "subsidized" with credits or deductions, which would allow everyone to enjoy lower overall tax rates; however, the TCJA barely lowered tax rates (especially maximum ones). It bears repeating: when the government led by President Ronald Reagan eliminated a host of deductions in 1986, the maximum income tax rate was lowered from 50% to 28%, and it kept the deduction for state income taxes, which created a maximum rate of about 35% in the highest-tax states (which generally had lower top rates than they do today). Now the real maximum nominal rate is nearly 54% (including the 3.8% Net Investment Income Tax) and, with no deduction for state income taxes, we could see a real maximum rate as high as 67% for some California residents. This will affect few taxpayers because they will use strategies to lower their rate when possible, including the strategy of simply working fewer hours and producing less income, which is bad for everyone.

Some economists suggest the mortgage deduction sets the stage for bubbles in housing markets, but evidence of massive bubbles in countries with no mortgage interest deduction fails to support this assertion. Prices have been driven to unsustainable levels in Canada, Australia and New Zealand without the benefit of tax savings on deductions for mortgage interest. And despite having had mortgage deductibility in the U.S. for decades, bubbles didn't appear until government created super-easy money and pushed lenders (by threatening banks with severe penalties for non-compliance) into making loans to borrowers who couldn't repay those loans. (As former Countrywide Financial Services executive Michael Winston put it, "We will give a loan to anyone who can fog a mirror." A common acronym was

NINJA, or "No Income, No Job or Assets" loans, which would never have been made had they not been incentivized by government rules.)

Other economists argue that the mortgage interest deduction encourages the purchase of main homes, which is better for long-term economic and social stability. Yet a comparison of home ownership rates in various countries belies this assumption. The rate of home ownership in the United States is 64%; in the mess that is Greece, it's 74% and in arguably the most stable country on the planet, Switzerland, it's 43%. It may, however, incentivize the purchase of larger homes.

The combination of fewer deductions, the lowered deductibility limit for mortgage interest and a higher standard deduction will give way to no itemized deductions for most people. (In effect, Congress has backed into a partial repeal of the mortgage deduction.) With interest rates still near historic lows, the maximum yearly interest on a $250,000 home loan at 4.5% is $11,250; the interest on a $500,000 home loan at 4.5% is $22,500. The new federal standard deduction for married filers is $24,000, the combined limit to state and local income tax and property tax is $10,000, and deductions for unreimbursed employee business expenses and investment expenses were repealed. Lacking large deductions for medical expenses or charitable donations, the first $14,000 of additional deductions will be concentrated for most filers in "using up" the new standard deduction. The few remaining itemizers will generally gain little benefit from the mortgage interest deduction.

To the extent of reduced tax savings, Congress made homeownership more expensive, which theoretically should cause prices to drop. However, the new QBID, along with changes to depreciation rules that allow for much quicker depreciation deductions for some rental property owners, serve to decrease both the absolute and relative tax rate on net rental income. This increases the return on investment for most rental property owners. Hence, the net effect of tax law on housing values may be nil, with positive effects offsetting negative ones. On the other hand, the effect of rising interest rates is and will be negative, but that's an entirely separate issue.

The charitable deduction is tempered by an increase in the standard deduction

The charitable deduction is safe. The charitable deduction is moot. Huh?

The increased standard deduction dwarfs the amount most people donate to charity. This could cause a reduction in charitable contributions due to lowered tax savings from making donations.

An example will help explain why. Using what are now ancient rules from 2017, take a joint filer with $12,000 of non-charity qualifying itemized deductions (state and local income and property taxes, medical costs that exceeded 10% of AGI and miscellaneous itemized deductions, most of which must exceed 2% of AGI before inclusion as an "itemized deduction"). The standard deduction was $12,700 ($6,350 for single filers). Until actual deductions exceeded the standard deduction, charitable donations didn't save a dime in taxes. So, a donation of $700 saved nothing; a donation of $2,700 saved the tax on $2,000 at the filer's marginal rate. If that rate was 25%, the donation saved $500. Thus, if the goal is to donate $2,700 net out of pocket, an additional donation of $500 would be affordable (and then a bit more because tax is saved on that additional donation as well).

If the goal, however, is to donate $2,200 after any tax savings, a rational non-itemizer doesn't up the ante to $2,700, does she? A taxpayer would, with a $500 tax savings, donate $2,700; one who doesn't itemize gives $2,200. She doesn't donate that extra $500, because there is no $500 tax savings to offset the extra donation. (Overall lower tax rates leaving more money in people's pockets will at least partly offset this; the question is, were taxes lowered by enough to completely offset it? We doubt it but could be wrong.)

This is roughly what occurs with the new standard deduction of $24,000 built into the TCJA ($12,000 for single filers). If costs are calculated rationally, a newly non-itemizer's net gifting will drop. If everyone's donations drop, charities in the aggregate will receive less revenue. Since too many expect government to (ineptly) do what charities do (generally, far more competently), what might this do to the demand for government "services"? It could increase the demand for government to take over functions currently performed by private charities. This is similar to the idea that curtailed deductions for state and local income or sales and property taxes may cause the demand for the federal government to take over many functions of state government.

U.S. citizens are the most generous people on earth in terms of charitable giving, perhaps because ours is the only country to be founded on the principle of individual liberty and self-reliance, in which the Founders wanted as little government as possible intruding into our lives. But free people know that occasionally people fall on hard times; one of the purposes of private charity is to get people through those hard times so they can stand on their own. We've drifted far from these founding principles. Wouldn't it be ironic if the Party that purportedly supports economic freedom is the one that creates malincentives in tax law that causes us to move further from those ideals?

In our view, charitable giving should be a straight deduction from taxable income or, even more ideally, a dollar-for-dollar credit against tax otherwise owed. After all, government has proven itself time and again incompetent to care for the indigent. Those who are most deserving of help often don't get it; those least deserving game the system. With tax credits for charitable giving, government could relinquish the allocation of scare resources intended for those in need; private competitive charities would do a much bet-

ter job of it.

Personal casualty losses reduce wealth; they should be fully deductible

Casualty losses are safe. The casualty loss deduction is no more. Huh?

The deduction for personal casualty losses for uninsured hurricane/ tornado, flood, fire, earthquake, burglary or investment casualty (theft of savings or investment) losses was eliminated, *unless* the loss occurs in a Presidentially-declared disaster area.

This is discriminatory on its face. Why should some casualties of the same type, whether wind, water, earthquake or fire damage, be favored over others?

The idea behind an income tax is to tax increases in wealth (which in itself, perversely, reduces the increase in wealth, but I digress). A deduction for a sudden decrease in wealth on which taxes have already been paid seems to us a rational and fair way of returning some of the tax on the lost wealth, imperfect a system though it may be.

Let's say you purchase $50,000 of Bitcoin with money that's already been taxed (i.e., not in a retirement account). An unknown person or persons manages to steal your Bitcoin (this does happen). Without a deduction for the loss, you're out not only the $50,000, but also the taxes you paid to earn the $50,000, which might have been as much as ($50,000 / inverse of the new maximum tax rate of 64% for CA taxpayers = $139,000 - $50,000 =) $89,000. So, you could be out a total of $139,000 (you'd have had to earn as much as $139,000 to have netted $50,000 to buy the Bitcoin). A deduction of $50,000 didn't begin to cover the real extent of the loss.

Under prior law, a deduction was allowed for personal casualty losses only to the extent they exceeded $100 per incident (a leftover from now ancient law) plus 10% of Adjusted Gross Income. Until the loss exceeded this figure, there was no tax savings. Further, you needed to itemize deductions for any loss to begin to count; so, until the total of what's left of itemized deductions exceeded the old standard deduction there was zero tax savings. Under the TCJA, unless the loss occurs in a Presidentially-declared disaster area (impossible for a simple household fire, burglary or investment casualty loss), it's non-deductible. Even in Presidentially-declared disaster areas, losses won't begin to save tax until losses plus other itemized deductions exceed your new higher standard deduction.

We'd suggest that non-Presidentially-declared losses should, at a minimum, get the same dismal treatment as losses occurring in Presidentially-declared disaster areas. But we'd go further: since such losses constitute a reduction in net wealth, they should arguably be fully deductible without having to exceed 10% of income. or require itemized deductions.

The loss of the deduction is especially egregious for investment casualty losses ("Ponzi" schemes, named for the alcoholic who charmed his marks out of $20 million in 1919-1920). These cannot be insured against. They were responsible for an enormous loss of wealth in the 2008 stock market crash (and will likely be so in the next one). Before the TCJA, there was no 10% plus $100 threshold for thefts of investments; they were fully deductible once you itemized deductions. Our view is that these should also be "above the line" deductions (i.e., adjustments to income for which itemizing isn't required), since you already paid tax on the stolen savings.

In the meantime, don't expect to share personal losses with the federal government. This doesn't change our assertion that one should have high deductibles and high maximum limits of coverage for real catastrophes across all insurances. The only good news here is business and rental property casualty losses remain, generally, fully deductible (subject to having "basis" in the property insured).

The Roth Conversion is safe; the opportunity to change your mind: gone

Roth conversions are safe. Recharacterizations (undo's, or "Mulligans") are no more.

The fact that income is taxed yearly is an arbitrary artifact of the calendar. Why not over two years? Five? Ten? An attempt to mitigate the tax costs for those with volatile income swings, but only in an upward direction, was introduced in 1964, as "income averaging." Imperfect though it was, by allowing income to be "averaged" over four years (reduced to three in 1982), it created lower effective marginal tax rates for millions. It helped those who had sudden high incomes after having earned little or nothing for years while developing skills or building a trade or business. The Tax Reform Act of 1986 eliminated a host of deductions, along with income averaging, in exchange for dramatically reduced maximum advertised marginal tax rates.

I've long counseled clients to do their own "income averaging," by planning and strategically "smoothing" income over years or even decades. Careful smoothing, not just as income increases but even more so when it decreases, can reduce taxes by thousands and even tens of thousands of dollars. Congress, in an unusual act of benevolence to taxpayers, made such income smoothing easier beginning in 1998 with the creation of the Roth IRA, which allowed Roth conversions for those with incomes under $100,000 in the year of conversion (h/t to the late Senator William Roth, one of my few Congressional heroes). Conversions allow the transfer ("converting") of retirement funds (held not only in IRAs, but also in other retirement plans) to Roth IRAs. In exchange for paying tax on pre-tax converted funds, future growth in value is permanently tax-free. In 2010 the income limitation disappeared, allowing higher income earners to convert. With the invention of the "high-income traditional-to-Roth conversion strategy," discussed in issue # 27 of *Wealth Creation Strategies*, conversions turned out to be immensely profitable not only for temporarily lower-income taxpayers, but also for many higher-income taxpayers, allowing tax-free withdrawals in retirement.

The related great gift from a Congress not known for its beneficence was the Roth "recharacterization." This

allowed those who converted in one year to “undo” part or all of a conversion by the extended due date of the return the following year (often called a “do-over” or, in golf terms, a “Mulligan”), and pay tax on only the net amount converted. Recharacterizations allowed us to “fine-tune” taxable income, so we could “use up” low brackets and avoid paying tax at higher rates (often 25% +, with the caveat that the cut-off point varies by individual). While the TCJA allows Roth conversions to continue, recharacterizations are no longer allowed.

For many taxpayers, this could be a debacle.

Under old law, we created a “safety net” by exceeding our expected optimal conversion amount, and, when we had final tax return figures the next year, recharacterized part or all of a conversion that exceeded the agreed-upon or planned optimal amount. We purposely over-converted rather than under-converted because underdoing could leave zero or low tax-bracket money on the table. We generally didn’t want to miss paying tax at zero, 10% or 15% when we could.

The TCJA’s elimination of the ability to rectify an over-conversion will require more time to properly plan the conversion. It will be crucial to obtain more accurate full-year income and deduction figures than previously. There could be huge adverse tax consequences if a client forgets to give us something crucial to the determination of expected taxable income. Oftentimes, clients may not have anything close to final numbers before the conversion must be completed (prior to year-end) because there is unknown and often unknowable capital gains distributions from mutual funds, Partnership and S-Corporation income, or an event that occurs at the last second. Or, they simply forget to tell us about a $50,000 gain on a stock sale occurring early in the year (or maybe they thought it occurred the year before). The possibility that clients will over-convert (and thereby create too much income) will cause us to be more conservative for 2018 and future planning. This is especially so in the case of several clients for whom tax rates rocket from zero to 30% and even 40% over a $4,000 stretch of income, due to the nearly instant phase-in of long-term capital gains and taxable Social Security and/or a phase-out of tuition credits.

Why did Congress take away this valuable tax-planning tool? They wanted to end a strategy that took advantage of the system, which had to do with investments. Those relatively few converted IRAs in equal amounts to two Roth IRAs. One conversion held aggressive stocks in long positions; the other was held “short,” which can be done indirectly by buying ETFs that short stocks, or something similar, which was expected to change value in the opposite direction. They waited to see which Roth conversion did better and “kept” that conversion (they created permanently tax-free income this way); they recharacterized the conversion that dropped in value. None of our clients have done this; ours recharacterized strictly for tax savings. It’s been immensely profitable for many and will continue to be, for the price of having to be much more careful when planning.

Congress could easily have eliminated this perceived “gaming” of the system by requiring aggregation of Roth conversions so the investment strategy ploy couldn’t be used. Or, they could have limited the amount one could recharacterize to something like $50,000 (or even $25,000). Instead, Congress complicated the greatest opportunity to smooth income for the average Joe (and Josephina) ever.

We will continue to emphatically recommend conversions for clients whose marginal tax brackets are expected to increase in future years. We’ll just have to be conservative and more careful.

Qualified Business Income Deduction (QBID) limitations

The QBID maximum taxable income limits for those with “Specified Service Businesses” (SSBs) serve to increase the marginal tax rate on a $50,000 ($100,000 for joint filers) “chunk” of income to as high as nearly 50%, plus 3.8% Net Investment Income Tax, plus state income tax of as high as 9.3% (for that income range for California filers), or about 63%. There is an enormous disincentive to produce more income as the QBID quickly disappears at taxable income levels above $157,500 ($315,000 for joint filers). What SSBs might earn that level of income? Doctors, dentists, veterinarians and other medical providers. Many lawyers, athletes, actors, singers, directors, entertainers, actuaries, consultants, financial brokers/service providers and the like. What will they do to keep their income below these levels? While some planning can be done, many will simply work less. What will that do to the supply of services? Decrease it. What will that do to prices in those sectors of the economy? Increase them. This won’t be good for wealth creation and, therefore, society.

Further, consider the U.S. Treasury. They will likely lose an enormous amount of revenue from affected people who might use planning strategies to avoid the phase-out, or who will simply stop working (producing) when they hit the phase-out zone (they are willing to work and keep 65% of what they earn but are not so willing when allowed to keep only 37% of what they earn). The phase-out of the QBID, likely required due to the need to pass the Act via “budget reconciliation” (after all, Republicans are generally averse to punishing productive individuals), is idiotic and destructive of both production and government revenue. As Arthur Laffer taught us, at some point on his “Laffer” tax curve, people simply stop working.

QBID may reduce the tax savings from making retirement plan contributions

Many taxpayers qualifying for the QBID will be subject to phantom, but very real, *lower* tax rates for purposes of determining the tax savings value of additional deductions, including pre-tax retirement plan contributions. In addition, since the QBID itself is an additional deduction from taxable income,

advertised marginal tax rates will drop for many self-employed individuals. When withdrawing funds in retirement, they won't have the benefit of the QBID and will pay tax at their "normal" marginal rate, which easily could be higher than the rate saved when making the contributions. As a result, we will advise many self-employed individuals to stop funding (or contribute less to) pre-tax retirement accounts. This was not likely intended. Congress could fix this by making retirement contributions deductible at the taxpayer's advertised rate rather than their QBID rate. But don't hold your breath.

Miscellany

529 plans expanded

New Coverdell savings accounts ("Educational Savings Accounts" or ESA's, used to create tax-free income when used for certain educational expenses) are eliminated (old ones are grandfathered), but 529 plan opportunities were expanded. Qualifying educational expenses paid for by a 529 plan now include up to $10,000 per student per year for pre-college expenses.

No income from or deduction for alimony beginning with divorce or separation agreements finalized in 2019 or later

The TCJA eliminated alimony as both a deduction by payers and income to recipients for decrees finalized after 2018. It appears Congress wanted to eliminate the income-splitting opportunities afforded by equalizing incomes via divorce. Old decrees or new restatements of old decrees are grandfathered.

The financial aspects of divorce will have to be carefully considered with this new rule in mind. The division of highly appreciated property and retirement plans still afford income-splitting opportunities; be sure to keep this in mind when finalizing divorce decrees.

California and Many Other States Do Not Conform to Federal Changes Under the Tax Cuts and Jobs Act (TCJA)

California does not conform to most provisions of the Tax Cuts and Jobs Act (TCJA). With already massive differences between the two tax systems becoming gargantuan, planning for and preparing both sets of returns will be challenging at best.

A number of states will not conform to many of the business provisions of the Act, but the most time-consuming differences concern the Schedule A miscellaneous deductions. At press time, we believe only Hawaii and California still allow these. The fact they are allowed is good because such deductions save tax for state itemizers (there will be many more itemizing for CA than for federal because the state standard deduction is relatively miniscule; see chart below); it's bad because these deductions will usually only save a modicum of tax—and you'll still have to keep the records for proper tax return preparation. Still, the extra effort will be worthwhile for most.

Comparison of the Federal and California Standard Deduction for 2018-on (Inflation-Adjusted)

	Federal Standard Deduction	California Standard Deduction
Single and Married Filing Separate	$12,000*	$4,401
Head of Household	$18,000*	$8,802
Married Filing Joint	$24,000**	$8,802

* Add $1,600 for Single and Head of Household filers age 65 and over

** Add $1,300 for each Married person age 65 and over

Here are just a few of the more nightmarish examples for which there is and will likely be no conformity by California.

Federal and California Non-Conformity 2018-on

Federal Schedule or Form	Deduction	Federal	California
A	Deduction of mortgage interest on acquisition indebtedness over $750,000 but less than $1.1 million for purchases since December 15, 2017	No	Yes
A	Deduction of interest on “equity” lines (including “cash out” refi’s) of up to $100,000 (retroactive)	No	Yes
A	Deduction of property taxes in excess of $10,000	No	Yes
A and 2106	Deduction of unreimbursed employee business expenses (including driving, temporary job locations, continuing education, tools, supplies and out-of-town travel)	No	Yes
A	Deduction of investment expenses (including advisory fees)	No	Yes
A and 4684	Deduction of casualty losses in non Presidentially-declared disaster areas	No	Yes
A and 4684	Deduction of casualty investment losses (“Ponzi-style” thefts of savings and investments)	No	Yes
C*, E* and 4562	A 100% first-year deduction (“bonus” depreciation) for most non-structural business and rental property (“5-year” to “20-year” property) **	Yes	No
C* and E*	Deduction of business “entertainment” (such as golfing, parties, concerts and sports games with customers, clients, prospects, etc.)	No	Yes
C*, 4797 and 8824	Tax deferral of profit on “trade-ins” of non-real business-use vehicles, equipment and other 5- to 20-year property (essentially, other than 27.5-year and 39-year real property)	No	Yes
D and 8824	Tax deferral of profit on tax-deferred exchanges of collectibles and cryptocurrencies	No	Yes
1040 (income)	Alimony received taxable for post-2018 decrees	No	Yes
1040 (adjustment to income)	Alimony paid deductible for post-2018 decrees	No	Yes
1040 (adjustment to income)	Non-military moving expenses	No	Yes
1040 (income)	Tax-free distributions from 529 plans for K-12 education	Yes	No

* Schedule C and E changes also affect business and fiduciary entities (Partnerships, Trusts, Corporations and S-Corporations).

** Enormous differences for depreciation already existed pre-TCJA; this merely adds to them.