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What upcoming tax proposals mean for California taxpayers

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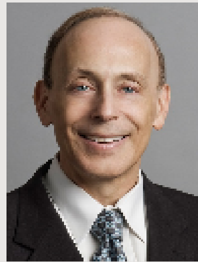

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It is too early to know whether President-elect Donald Trump's income tax proposals will be enacted. His most prominent proposal is to reduce the current seven income tax brackets to three: 33 percent (single people making more than $112,500, couples making more than $225,000), 25 percent (single people making between $37,500 and $112,500, couples making between $75,000 and $225,000) and 12 percent. His plan will cap itemized deductions ($100,000 for single people, $200,000 for couples), and fix the capital gain rate at 20 percent.

The Republican party's plan has more detail, so it is worth examining. It eliminates all itemized deductions, including one of critical importance to Californians: the state and local tax deduction. Deductions would continue for charitable donations, employer provided health care, education tax benefits and retirement savings. The Earned Income Tax Credit would remain and the Alternative Minimum Tax (AMT) would be eliminated. The most important difference from current law for individuals is that all income from capital, including interest, dividends and capital gains, would be taxed at half the rate of labor income, i.e., 16.5 percent.

For California, the 2016 maximum ordinary, earned income, rate was 39.6 percent federal plus, if not in the AMT, a deductible 13.3 percent state, effectively 8.032 percent, for a total of 47.632 percent. The state tax deduction saved (13.3 - 8.032 =) 5.268 percent. In 2017, the federal rate drops from 39.6 to 33 percent, a 6.6 percent reduction. However, the lack of a state tax deduction increases the rate by 5.268 percent. The net reduction is, therefore, only (6.6 - 5.268 =) 1.332 percent! So in the 2017 maximum earned income rate will be 97.2 percent of what it was in 2016, an almost imperceptible change.

In 2016 an additional 3.8 percent, the tax on net investment income, sometimes referred to as the Obamacare tax, was due on passive income. Will that be repealed in 2017? If so, while the Affordable Care Act continues for another two years to allow for transition to a new system, the revenue loss will create a large hole in the federal budget. However, assume a 2017 repeal. Passive income was taxed in 2016 at (39.6 + 3.8 + 8.032 =) 51.432 percent. In 2017 it becomes (33 + 13.3 =) 46.3 percent, the same as for earned income. The rate reduction is (51.432 - 46.3 =) 5.132 percent. Therefore, the 2017 rate will be 90 percent of the 2016 rate. That, at least, is noticeable.

There were two possible maximum capital gain rates in 2016: one for people who were passive and another for those who materially participated in the activity. (Both calculations assume you were in the AMT.) The first was 20 federal + 3.8 federal + 13.3 state = 37.1 percent and the second was 20 federal + 13.3 state = 33.3 percent. The 2017 rate for Californians will either be 20 percent (the president-elect's rate) + 13.3 percent = 33.3 percent or 16.5 percent (the Republican party's rate) + 13.3 percent = 29.8 percent. If the president-elect's plan prevails, Californians will have a capital gain rate that is 89.76 percent of what it was in 2016 for passive gains and 100 percent of what it was for active gains. If the Republican party's plan is enacted, Californians will have rates which are 80 (passive) or 89.5 percent (material participation) of what they were in 2016.

Nevada's advantage will increase if state and local taxes are no longer deductible. In 2016, Nevada residents paid 39.6 percent (active) or 43.4 percent (passive) on ordinary income. That compared to the California rates of 47.632 and 51.432 percent. The Nevada rates were 83 and 84 percent of those in California; the rate differences were 8.032, the value of the federal tax deduction. For every $1 million of ordinary income, you would save $80,320 by moving to Nevada. For virtually all of our clients, that was not enough to warrant leaving. Others figured that $80,320 was about enough to cover a $1.5 million mortgage, so it was enough reason to move. For 2017, Nevada's 33 percent rate is 71 percent of California 46.3 percent rate, meaning the Nevada advantage has increased due to the loss of the federal deduction for state and local taxes. The savings of (46.3 -- 33 =) 13.3 percent $133,000 per million, enough to pay a $2.3 million mortgage will cause more people to move to a no-tax state.

Nevada's capital gains advantage increases in 2017 compared to 2016 for passive gains, especially if the Republican party's rate prevails. In 2016 the rate differentials were 37.1 vs. 23.8 percent for passive gains, giving Nevada a 13.3 percent advantage, meaning Nevada's rate was 64 percent of California's. For active gains the rates were 33.3 vs. 20 percent, giving Nevada the same 13.3 percent advantage, meaning Nevada's rate was 60 percent of California's. In 2017 the rates will either be 33.3 vs. 20 percent, the same as they were in 2016 for active gains, or 29.8 vs. 16.5 percent. In both cases the rate differential is the 13.3 percent California tax. In the first case Nevada's tax is 60 percent of California's and in the second Nevada's tax is 55.4 percent of California's.

What does this mean for 2017 tax planning? Since the combined federal and state tax rate for ordinary income is still so high 46.3 percent the incentive to do ordinary income tax planning will remain strong. That is especially true since the figures above do not consider the impact of the elimination of or cap on deductions. Of course, with those restrictions on deductions, there will be a premium on income tax planning since so many previously existing avenues may disappear. More people will decide to flee California for no-tax states. For capital gains tax planning, 33.3 percent (the president-elect's rate) will still cause many taxpayers to pursue ways to defer or eliminate capital gains. At the Republican party's 29.8 percent rate, some people will decide to pay the tax and avoid the complexity of planning. It will be an interesting year.