What the New Tax Reform Means for You and Your Firm: Four Experts Weigh In

MARK R. BARAN
Principal, Tax Practice
212.503.8991
mbaran@markspaneth.com

MARKS PANETH
ACCOUNTANTS & ADVISORS

JOE BUBLÉ, CPA
Partner, Tax Practice
212.697.1000
jbuble@cintrincooperman.com

CITRINCOOPERMAN®
Accountants and Advisors

ABE LEITNER
Director, Tax Group
212.878.5158
aleitner@goulstonstorrs.com

goulston&storrs

MATHEW D. TALCOFF
Partner, Tax Services
617.241.1216
mathew.talcoff@rsmus.com

RSM

With the Republican tax plan now signed into law by President Donald J. Trump, many New Yorkers are rushing to their accountants' offices to make sense of how it will affect their personal tax situation and, if they run a business, their company's finances as well.

The tax law—the first major reform of the U.S. tax code since 1986—is ushering in some important changes, which will be applied in 2018. When it comes to personal taxes, the exemption for individuals will rise from $6,350 to $12,000 and for couples from $12,700 to $24,000. Fewer people will be affected by the dreaded alternative minimum tax (AMT), with the exemption increasing to $70,300 for individual filers and to $109,400 for married couples.

At the same time, however, the $4,050 personal exemption is being eliminated. The reform is also bringing a $10,000 cap on the state and local tax deduction—a blow to those in high-tax states such as New York. Plus, new home buyers will only be allowed to deduct interest on the first $750,000 of their mortgage debt, also a potential challenge to New Yorkers, given high local housing prices.

On the business front, there will be a permanent corporate tax rate reduction from 35% to 21%, elimination of the corporate AMT, and new ceilings on net operating losses and net interest expenses.

To gain clarity on some of the details and what they mean for readers, Crain's Custom recently asked a panel of accountants from leading tax and law firms in the city to offer their insights on some of the most commonly asked questions they are encountering in their New York City practices.

Our brain trust consisted of:
•Mark R. Baran, principal of the tax practice at accounting, tax and advisory firm Marks Paneth LLP
•Joe Bublé, a tax partner at assurance, tax and advisory firm Citrin Cooperman, who leads the firm's tax practice
•Matt Talcoff, partner at audit, tax and consulting services firm RSM US LLP
•Abe Leitner, director in the tax group in the New York office of law firm Goulston & Storrs.

Here is their take on some key areas of the tax reform.

***Crain's*: What are the three most significant changes for corporations in the tax reform bill?**

Mark R. Baran: The permanent corporate rate reduction from 35% to 21% and repeal of corporate AMT are two of the most favorable corporate provisions, for the obvious tax savings that will result. On the flip side, new limitations on net operating losses (NOLs) and the net business interest expense are significant, but much less welcome, changes.

For most businesses, the provision that allowed NOLs to be carried back two years has been repealed, and the NOL deduction is now limited to 80% of taxable income. New limitations also apply to the business interest expense deduction for all companies except those with annual gross receipts below $25 million over a three-year period.

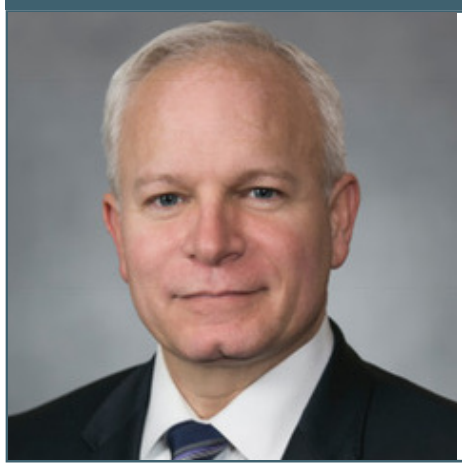
Joe Bublé: The reduced rate for C corporations was enacted to encourage corporations to keep more of their operations in the U.S. In addition to the unfavorable new interest expense and net operating loss limitation rules, there are a number of favorable accounting method changes that will help small businesses.

The new law also repeals the exceptions to the limitations on excess employee compensation for covered employees of public companies. Under the previous law, exceptions applied to commissions and performance-based remuneration, including stock options. The compensation limitation remains at $1 million per year, but the new law repealed these exceptions.

The new law also reduces the corporate dividend received deduction. The 80% dividend received deduction under the previous law is reduced to 65% and the 70% deduction is reduced to 50%.

Matt Talcoff: The C corporation income tax rate dropping from 35% to 21% produces an all-in top income tax rate for individual corporate shareholders of 36.8% (39.8% when including the net investment income tax). This tax rate is close to the new top individual income tax rate of 37%. That reduction is tantamount

Principal of the tax practice at accounting, tax and advisory firm Marks Paneth LLP



"Some businesses may benefit from the simplicity of using the cash method of accounting."

MARK R. BARAN MARKS PANETH ACCOUNTANTS & ADVISORS

to the virtual elimination of the so-called "double tax" on corporate income if the income was taxed at the highest individual rate. However it is important to note that certain pass-through income could be taxed at lower rates. For example, some pass-through income could be taxed at an effective 29.6% rate which is why the choice of an entity requires discussion and analysis.

The corporate AMT is also being eliminated. On the negative side, new limitations are imposed on deducting business interest and net operating losses.

Abe Leitner: In addition to the change to the corporate tax rate, the most significant changes to the corporate tax landscape include the shift to a territorial system of international taxation in the form of a new dividends received deduction and a new 20% deduction, equivalent to a 16.8% effective tax rate, for foreign derived intangible income (FDII). This category--much broader than its name implies--includes most sales of goods or services to foreign customers. In truth, the new 30% limitation on deducting business interest expense will probably have a broader effect on corporations than the FDII deduction, but the 30% limitation also applies to non-corporate businesses.

***Crain's*: How will the reduced federal tax rate impact the deferred tax assets and liabilities for financial statement reporting purposes?**

Joe Bublé: Under ASC 740, the effects of a change in tax law must be recognized in the period in which the law is enacted, in this case, December 22, 2017. Fiscal year-end companies must recognize the effect by the change in the interim period of the enactment. These changes will result in the revaluation of a company's deferred tax assets and liabilities. The impact of the tax law change needs to be reflected directly in income tax expense or benefit from continuing operations, including items of deferred tax that were originally accounted for in other comprehensive income. Even though enactment of most provisions is not until 2018, the filing of 2017 financial statements requires the disclosure of this subsequent event and the impact on tax accounts.

Abe Leitner: The reduction in federal tax rates will generally shrink the value of deferred tax assets and liabilities. For companies whose deferred tax assets exceed their deferred tax liabilities, there will be a net negative effect on the balance sheet. On the other hand, for companies whose deferred tax liabilities exceed their deferred tax assets, there will be a net positive effect.

The impact of the enacted law changes will have a broad impact on the four assertions of financial statements: recognition, measurement, presentation, and disclosure.

Matt Talcoff: With the reduction of the corporate tax rate from 35% to 21%, businesses will need to restate their deferred tax assets and liabilities on their financial statements to account for the effective tax rate on when those deferred items will reverse. For example, a company which had a $1 million piece of equipment that was deducted for taxes in 2017 at a 35% tax rate saved $350,000 of current federal income taxes. If the financial statement depreciation would occur over the following seven years, then the deferred tax liability on the financial statement would have been $350,000. However, with the lower 21% corporate tax rate, the deferred tax liability will now only be $210,000, resulting in a permanent tax benefit of $140,000. Detailed scheduling will be necessary due to the uneven nature of many provisions.

Another example is that for corporations with average annual gross receipts of $25 million or more, a new limitation on the deductibility of interest expense is 30% of taxable income without regard to deductions for depreciation, amortization, or depletion through December 31, 2021. However, for the years after January 1, 2022, the limitation is based on taxable income considering those items. That will magnify the impact of any interest limitation carryover from 2021 to 2022 and require a company to consider whether any valuation allowance is necessary related to the extent to which that deferred tax asset can be realized.

***Crain's*: What are the main issues and opportunities a business owner should consider when choosing between continuing to operate as a flow-through entity (such as an S Corp, LLC or Partnership) as opposed to converting to a regular C Corporation due to the lower 21% corporate tax rate?**

Joe Bublé: One of the main issues to consider is the effective federal tax rate under various alternatives. A business owner with flow-through income from a business will pay federal taxes on the flow-through income of about 30%, assuming the business qualifies for the 20% deduction and is not otherwise limited. If the business does not qualify for

Tax partner at assurance, tax and advisory firm Citrin Cooperman, who leads the firm's tax practice

"The reduced rate for C corporations is meant to stop them from shifting income to lower tax countries and increase wages for US employees."

JOE BUBLÉ, CPA

CITRINCOOPERMAN®
Accountants and Advisors

the 20% deduction, the top tax rate is 37%. If the business elects to be taxed as a C Corporation, the federal tax rate will only be 21% at the entity level.

However, if the business typically distributes all after-tax earnings to the shareholders, the effective tax rate spikes to about 40% for C Corporation shareholders and will stay around 30% or 37%, respectively, for the flow-through business owner. Additionally, if the entity sells its business, the C Corporation structure may be tax-inefficient for an asset sale. In addition, the impact of self-employment taxes where applicable, net investment income tax and state and local taxes should also be analyzed.

Abe Leitner: A shareholder of a C corporation still faces a second level of tax on dividends distributed from the corporation. Although the federal tax rate on dividend income is lower than the rate on other ordinary income (since dividends are generally taxed at the 20-percent rate that applies to long-term capital gains), the combined rate on income subject to such double taxation is 37.6%, which is slightly higher than the 37% maximum rate on income earned through a flow-through entity. Also, corporations may be subject to a second level of state and local taxation. Accordingly, a flow-through entity probably makes more sense for most small businesses that distribute the bulk of their income to their owners currently.

C corporations may be more attractive to businesses that reinvest a lot of their earnings and can benefit from deferring the second level of shareholder tax. C corporations may also be attractive for businesses with international operations due to the special benefits for foreign income in the recent Code changes.

Mark R. Baran: To the extent a corporation retains earnings, the benefits of converting to a C corporation become more relevant. In this situation, only one level of tax at a lower 21% rate would apply to corporate earnings until such time a dividend is declared. Other provisions impacting the decision to convert to a C corporation that should be part of any tax projections include the repeal of the corporate AMT, expanded expensing for certain business assets and new thresholds for favorable accounting methods. Finally, the costs related to converting any flow-through entity should be carefully evaluated. Oftentimes, a conversion is not a tax-free transaction.

Matt Talcoff: One important consideration is determining an owner's exit strategy. A business owner who will hold the business and transition it to family members may benefit from the lower 21% federal income tax rate for C corporations, while a business that may sell in the next few years may be better off keeping its current flow-through entity structure, as many buyers want to acquire assets which unfortunately would result in a double tax to the seller in a C corporation scenario.

Another consideration is to decide whether you think the new rules will not be changed again in a few years, as often happens with major tax reform legislation, particularly if it is passed on a party-line vote. Let's say you are considering C corporation status for its tax rate advantages and the ability to defer a good portion of the tax that would otherwise be due on reinvested earnings. If you view the new law as relatively permanent, then you must still determine whether in fact you will reinvest most of your income or distribute it currently.

***Crain's*: As a C corporation, is there a benefit to converting to the cash basis if the company meets the new $25M gross receipts test? Is it easy to convert?**

Mark R. Baran: Some businesses may benefit from the simplicity of using the cash method of accounting. Corporations converting from an accrual method to a cash method may incur an immediate income recognition and must weigh this one-time tax charge against the overall savings and benefits of using the cash method of accounting. The process of converting requires the filing of a Form 3115 "Application for Change in Accounting Method." There are eligibility requirements other than the new $25 million threshold. These include, but are not limited to, whether a taxpayer has inventory, is under IRS examination, or is a tax shelter or an S corporation.

***Crain's*: How is the 20% pass-through deduction calculated?**

Matt Talcoff: A new exclusion or deduction of 20% of qualified business income will effectively reduce the tax rate on such income by 20%. Thus, qualified income otherwise taxed at the top rate of 37% will be taxed at 29.6%. Income otherwise taxed at 24%, for example, will be taxed at 19.2%.

For individuals with income below $315,000 for joint returns, it is pretty simple. For every $100 of business income, only $80 is subject to tax. The computation

Director in the tax group in the New York office of law firm Goulston & Storrs

"One of the new huge benefits for corporations in the tax reform bill is a new 100% dividends received deduction for dividends from foreign subsidiaries."

ABE LEITNER

goulston&storrs

is the same for higher-income taxpayers, except that more restrictions apply to qualify for the deduction. The business must either pay substantial wages (twice the amount of the 20% deduction being claimed) or invest in substantial amounts of tangible, depreciable property used in the business. In addition, the business may not be on a list of forbidden service businesses in various fields such as law, health, accounting, consulting, brokerage, financial services, performing arts, actuarial science, and some others.

***Crain's*: Will I be able to deduct the interest I pay on my business loan to the bank?**

Mark R. Baran: It depends. The unlimited deduction is still permitted for businesses with less than $25 million in gross receipts and for certain real property-related business activities. However, all other businesses will see new limitations. The new amended section 163(j) limits the net interest deduction to 30% of adjusted taxable income. During tax years 2018-2021, the deduction is limited to earnings before interest, taxes, depreciation and amortization (EBITDA). After 2021, the deduction becomes less valuable as it will then be limited to earnings before interest and taxes (EBIT). Unused net interest expenses may be carried forward indefinitely.

Joe Bublé: Real estate entities can make an irrevocable election to avoid the interest limitation but have to extend depreciable lives in exchange.

For pass-through entities, the interest limitation is calculated at the entity level. Any disallowed interest is passed through to the owner to be used in future years.

***Crain's*: Service trades or businesses (over certain income thresholds) are excluded from the new partnership qualified business income deduction. How does the definition of service trade or business differ from the qualified small business stock definition?**

Matt Talcoff: As noted, certain service trades or businesses are generally ineligible for the 20% deduction if they exceed the income threshold. Using language from section 1202 (the qualified small business stock definition), specified trades or businesses include any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services. Certain financial trading and dealing activities are also excluded. Engineering and architectural firms were removed from this "bad" list in the final enacted legislation but are included in the definition of qualified small business stock in Sec. 1202.

However, there is a catch-all category that is somewhat vague and confusing. It excludes any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. This test could effectively bring architects and engineers back into the forbidden list – and exclude many other businesses – possibly in a manner that was not intended.

On the other hand, it is not clear that similar words in section 1202 and the new pass-through rules will be interpreted and applied similarly because the policies of the two provisions are quite different. We are awaiting more guidance from the IRS on these matters.

Joe Bublé: The new law disqualifies certain taxpayers from using the Section 199A deduction by referencing a subsection under Section 1202 and then modifying that subsection. The Section 1202 subsection that is referred to excludes businesses that provide the following types of specified services: health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset is the reputation/skill of one or more its employees/owners.

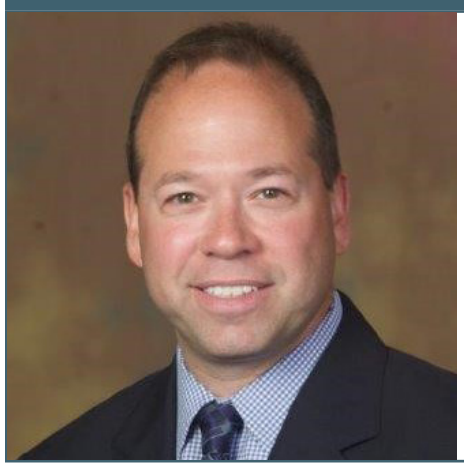
The new law then modifies that definition by excluding architects and engineers (so these businesses qualify for the deduction) and adds businesses that perform services consisting of investing and investment management, trading or dealing in securities, partnership interest and commodities.

***Crain's*: Will the state allow me to claim the 20% qualified business income deduction?**

Matt Talcoff: For federal tax purposes, the 20% qualified business income deduction (Section 199A) is a reduction to federal adjusted gross income (AGI) to arrive at federal taxable income. Rather than directly conforming to the Federal Internal Revenue Code for individual income tax purposes, many states like New York use federal AGI as the starting point for determining state taxable income, and provides for specific adjustments (additions and subtractions) to arrive at state taxable income.

Accordingly, it appears that New York's computation would

Partner at audit, tax and consulting services firm RSM US LLP



"A business owner who will hold the business and transition it to family members may benefit from the lower 21% federal income tax rate for C corporations..."

MATHEW D. TALCOFF

RSM

not include the 20% qualified business income deduction absent a specific state-level adjustment. As of the publication of this article, New York has not enacted provisions allowing for a state-level Qualified Business Income deduction.

***Crain's*: The international provisions in the tax reform bill contain huge benefits for corporations that are not available to individuals. Can you comment on some of those and explain why they are so important?**

Abe Leitner: One of the new huge benefits for corporations in the tax reform bill is a new 100% dividends received deduction for dividends from foreign subsidiaries. It allows earnings from offshore operations to be repatriated to the United States tax-free. Individuals are not eligible for this deduction.

In addition, while there is a new rule requiring all U.S. shareholders of controlled foreign corporations (CFCs) to include the global intangible low-taxed income (GILTI) of the foreign corporation in the shareholder's income in the year it is earned by the CFC, corporations are eligible for a 50% deduction against their GILTI inclusion along with a foreign tax credit, which effectively reduces the federal tax rate on such low-taxed foreign earnings to somewhere between zero and 10.5%. Individuals are not eligible for this deduction and face a 37% federal tax rate on any such low-taxed income of their CFCs. Finally, individuals are not eligible for the new FDII deduction applicable to income from sales and services to foreign customers.

Mark R. Baran: Corporations receive a 50% reduction in the new Global Intangible Low-Taxed Income (GILTI), while individuals pick up this new type of subpart F income at 100%. Combined with the lower corporate rate of 21%, that's about a 10.5% effective federal tax rate on this income for a corporation versus a potential 37% rate for individuals.

Corporations also get a deduction for foreign derived intangible income (FDII), which is not available to individuals. The FDII is formula-driven, based on a return on investment in qualified assets. Intangibles are not a factor in the calculation, and the benefit exists even if there are no foreign intangible assets.

***Crain's*: What are the repatriation tax rates applicable to individuals, partnerships and LLCs?**

Mark R. Baran: H.R. 1 imposes a one-time deemed repatriation tax if you own 10% or more of a foreign corporation, other than a passive foreign investment company. Individuals, partnerships, estates and trusts are all subject to the tax, while there is a deferral for S corporations and special rules for REITs. This tax will be assessed on the untaxed retained earnings and profits (E&P) of the foreign corporation at a rate of 15.5% on E&P invested in cash and cash equivalents and 8% on the remaining amount of E&P. There is a partial foreign tax credit on the affected E&P, as well as an election that allows a taxpayer to spread the pickup of the tax liability over eight years (8% due in years 1-5; 15% in year 6; 20% in year 7; and 25% in year 8). Furthermore, nothing in the new tax law limits the utilization of any foreign tax credit carry-forwards incurred prior to 2017.

Abe Leitner: The repatriation tax rates are determined by a formula that applies a deduction designed to reduce the rate on such income in the hands of a corporation to 15.5% for earnings invested in "cash positions" (which include marketable securities) and 8% for earnings invested in other business assets. For individuals, the same deductions translate into tax rates of 17.5% for earnings invested in cash positions and 9.05% for earnings invested in other business assets.

Joe Bublé: Everyone is talking about the corporate tax rates of 15.5% and 8% for deferred earnings invested in cash and illiquid assets, respectively. However, the rates applicable to individual shareholders could be significantly higher. These rates are derived via a deduction mechanism tied to the maximum corporate tax rate of 35%. The same deduction mechanism then needs to be done for individuals, substituting the 35% rate with the maximum individual rate of 39.6%. The computation then yields tax rates of approximately 17.5% and 9.05%, respectively, for individual shareholders and individual partners/members of partnership/LLC shareholders. Under the right circumstances, it may be beneficial for an individual shareholder to make an election to be taxed as a C corporation. The only U.S. shareholder for which the repatriation tax is not mandatory is an S corporation, but it becomes mandatory upon a triggering event.

In addition, the Net Investment Income tax of 3.8% applies to actual distributions, which cannot be deferred over eight years as the repatriation tax can.