What New York Taxpayers Need to Know About the New Tax Landscape

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On balance, the 2017 Tax Cuts and Jobs Act may not have brought true "simplification," but it did bring meaningful changes to the tax code. And taxpayers in New York must deal with the added tangle of state and federal rules that frequently contradict each other. Throw in the Supreme Court decision in South Dakota v. Wayfair, Inc., and New York business owners are staring at a 2019 full of new acronyms, new strategies and new tax compliance burdens.

To bring light to the relative darkness, Crain's turned to four experts in tax planning to explain what the TCJA means for corporate and individual taxpayers in 2019.

They are:

- **Joe Bublé**, a tax partner at Citrin Cooperman's New York office and the firm's tax practice leader. He specializes in tax planning and sophisticated tax research for businesses and individuals.
- **Joseph M. Giampapa**, a partner in Marks Paneth LLP's tax group. He has more than 15 years' experience in tax preparation for high-net-worth individuals, partnerships, corporations, estates, trusts and private foundations.
- **Renata Stasaityte**, a senior tax manager at UHY's New York office. She provides tax planning and due diligence for complex transactions and represents clients before the Internal Revenue Service, New York state and other tax authorities.
- **Iraida Strokovskaya**, a partner in FLSV's business tax services group. Her clients include private equity funds, closely held entrepreneurial businesses and middle-market companies across a wide range of industries.

Crain's: Did the Tax Cuts and Jobs Act result in tax simplification?

Bublé: No, it didn't. In fact, it added to the complexity. The individual alternative minimum tax was retained and brand new provisions that are exceedingly complex were added—such as the 20 percent qualified business income deduction and the interest expense disallowance rules, to name only a few of the changes. A new method of taxing foreign income of U.S. taxpayers was enacted and a "transition tax" regime was also added in order to effectuate the change. The IRS has issued hundreds of pages of proposed regulations on just these four topics so far. Furthermore, some changes are permanent and others sunset after eight years. Now, add in the fact that New York has decoupled from some of the federal changes and you can see that the TCJA was anything but simplification.

Stasaityte: I had a 70-year old college professor who taught me the three fundamental paradigms of taxation: only two things are certain in life—death and taxes; the correct answer to every tax question is "it depends"; and there is no such thing as tax simplification. The tax reform proved him right once more.

Strokovskaya: Individual income tax rates were reduced; personal exemptions were eliminated; the standard deduction was increased; and the ability to itemize deductions was limited. For individuals who do not itemize deductions, the TCJA may be viewed as simplifying the tax process. However, complications may still be found as not all states have conformed to the federal tax law changes and the "old" provisions may still apply at the state level.

From a corporate and pass-through entity perspective, the landscape has changed dramatically and increased in complexity. New acronyms such as BEAT, GILTI and FDII, in the international context, will add complexity to the tax compliance process. A 20 percent deduction was implemented for pass-through entities subject to significant restrictions and limitations. A new Qualified Opportunity Zone Fund Investment initiative was also implemented. Interest expense deduction limitations and new bonus depreciation rules have also altered the planning and calculation of a business's tax liability.

Giampapa: While the Tax Cuts and Jobs Act did result in some tax simplification, it also created complexity in many areas. For example, there are complicated calculations involved with the new Section 199A deduction and Section 163(j) interest limitation. We are also still waiting on finalized regulations for some of the new provisions, which has left many taxpayers and practitioners guessing how the IRS will view the treatment of their tax situations this year. It appears that the new U.S. tax regime will be far from simple.

Buble is a tax partner at assurance, tax and advisory firm Citrin and he leads the firm's tax practice.

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Crain's: How does New York state's decoupling from certain aspects of the TCJA affect taxpayers?

Stasaityte: It certainly adds to the complexity, uncertainty and confusion surrounding the tax reform. Not only does a taxpayer need to learn the new federal rules, but they must also figure out how each state, including New York, has responded to each change. For example, I am expecting that many individual taxpayers will miss the New York itemized deduction since it is no longer simply based on federal amounts. While New York is pretty quick to react to federal changes, many other states are a lot slower and have not issued comprehensive responses to the tax reform.

Giampapa: New York state taxpayers who have large deductions that are now deemed to be either limited or eliminated for federal purposes will still be able to enjoy the benefits of decreasing their state taxable income by these amounts (assuming they are below the $1 million New York adjusted gross income threshold). However, there are some pitfalls that taxpayers will want to avoid. Withdrawals made from a qualified tuition program to pay for kindergarten-through-12th-grade expenses, for instance, will not be considered qualified distributions and will be subject to tax on the earnings that are withdrawn. In addition, alimony received will have to be added to New York taxpayers' federal adjusted gross income in order to come up with their New York AGI, which will result in a higher state tax. Alimony paid, however, will continue to decrease taxpayers' New York AGI, even though it will not be a deduction to federal AGI going forward.

Strokovskaya: The foreign derived intangible income deduction, or FDII, will not be permitted for New York income tax purposes. Additionally, New York attempted to mitigate the effects of the cap on state and local tax deductions through the establishment of an additional payroll tax and local government and school district charitable funds. The IRS publicly indicated regulations will deem amounts contributed non-deductible. The state has also proposed a new business-entity-level tax for pass-through entities.

The budget left unaddressed other provisions, including global intangible low-taxed income, or GILTI, and Section 199A. For individuals, the calculation of New York income tax starts with federal AGI. Therefore, the Section 199A deduction appears to be unavailable to individual New York taxpayers, as the deduction is applied after calculating AGI on the federal return.

Bublé: In addition to New York State decoupling from TCJA laws affecting individuals, the state decoupled from a TCJA provision which increased a nonprofit employers' unrelated business taxable income by certain fringe benefit amounts. New York created a subtraction from nonprofits' federal unrelated business taxable income for fringe benefit amounts included under the new law. In decoupling from this provision, the New York legislature characterized the federal change as an unintended new tax that could divert millions of dollars from the nonprofit sector each year. Therefore by decoupling, NYS is not diverting additional money from the nonprofit sector.

Crain's: The TCJA includes a $10,000 cap on the deduction for state and local income and real estate taxes. How does that cap affect tri-state area taxpayers?

Bublé: The cap adversely affects taxpayers in the tri-state area who were not subject to the alternative minimum tax in prior years (or paid a small amount of AMT). Without the ability to deduct these taxes, the combined federal, state and local marginal tax rate for people in the top tax brackets is approximately 50 percent, depending upon the type of income. This is an increase of 11 percent from the 45 percent combined federal, state and local marginal tax rate from prior years.

Giampapa: With many in the tri-state area paying a fair amount of real estate taxes, as well as state and local income taxes, there are many taxpayers left with a higher tax bill due to the $10,000 cap on this deduction.

Giampapa is a partner in the tax group at Marks Paneth.

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Strokovskaya: Over time, it's possible we will see a migration of taxpayers to states with lower effective tax burdens. Business and personal opportunity costs as well as other operational considerations should factor into such a decision.

Stasaityte: While it has been certainly a focus of politicians in Albany and Hartford, we are actually finding that many taxpayers end up owing almost the same or less on the same levels of income. Many of the middle-class taxpayers were previously subject to the AMT, which disallowed state and local income and real estate taxes altogether, while the upper-class taxpayers were paying taxes at the marginal tax rates of 39.6 percent. The new tax reform contains some significant tax cuts for individuals—the reduced overall maximum rate from 39.6 percent to 37 percent, increased AMT exemptions, the new 20 percent deduction for flow-through income and increased standard deductions.

Crain's: Now that the corporate tax rate is 21 percent, should owners of pass-through entities consider converting to a C corporation?

Giampapa: While the 21 percent corporate tax rate is very attractive, there are many factors that should go into the decision to convert to a C corporation or to remain as a pass-through entity. One of the main considerations is whether the current partner/shareholder would want to take out dividends/distributions from the entity. If the answer is yes, then this could cause a double taxation on the dividends paid if the entity was a corporate taxpayer, thus eliminating some of the benefit of the lower tax rate. If capital is going to be kept in the entity, then becoming a C corporation is definitely more attractive, and a conversion could be warranted.

Bublé: The maximum individual federal tax rate on qualified dividends is 23.8 percent, which includes the net investment income tax. Assuming all of a C corporation's after-tax income is distributed, this results in a combined federal corporate and individual tax rate of 39.8 percent. This rate is slightly higher than the maximum federal individual tax rate of 37 percent and significantly greater than the 29.7 percent effective tax rate on income that qualifies for the qualified business income deduction. There are also state and local income taxes to take into account in any analysis.

Strokovskaya: Several additional tax and non-tax considerations should be carefully evaluated by taxpayers. For example, a second level of tax on corporate earnings is imposed on shareholders who receive dividends. A C corporation also needs to evaluate its personal holding company status and the applicability of the accumulated earnings tax. Pass-through entities provide the non-tax benefit of flexibility from an ownership and operational perspective. A pass-through entity also can allocate losses to the partners and allow more tax-efficient grants of equity. Additionally, an investment made into a pass-through entity could result in a basis step-up for the investing partner.

Stasaityte: As with any tax question, it depends. There is no "one size fits all" answer. There are multiple variables to account for—the conversion (is it possible to structure it as a tax-free transaction?), operations (projected tax liability as a flow-through versus as a C corporation), expansion (new capital infusions) and eventual exit (sale to a buyer or passing down the business to the next generation). We generally found that clients prefer to stay as a flow-through entity due to the eventual double taxation of C corporations, the new 20 percent deduction for flow-through business income and the political uncertainty about the longevity of the tax reform.

Crain's: How does the decrease in the corporate tax rate affect the amount of research and development credits a corporation can use?

Giampapa: Under the TCJA, corporate taxpayers will be able to gain the benefit of higher research and development credits. One reason for this increase is the elimination of the corporate alternative minimum tax. Large corporations (those with average gross receipts of more than $25 million

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for the last three tax years) can now enjoy the benefits of the credits since the TCJA eliminated the hurdle of the tentative minimum tax limitation.

Stasaityte: R&D credits are not refundable, meaning they can lower tax liability to zero but cannot generate a refund. With the lower tax rate at 21 percent, most corporations are looking at the lower tax liability and would need less of the R&D credit to get the tax liability to zero. Additionally, post-2017 net operating losses can now offset only 80 percent of taxable income. That means that even if a corporation has massive NOLs from prior years, it will still have some taxable income in a profitable year. Luckily, the R&D credit can help offset that.

Bublé: Before the TCJA, a taxpayer claiming R&D credit was required to reduce their deduction by the amount of the R&D credit. Alternatively, such a taxpayer could elect to take a reduced R&D credit. The amount of the reduction was the product of the R&D credit and the maximum corporate tax rate of 35 percent. As a result of the TCJA, the net benefit from the R&D credit increased from 65 percent (100 percent minus 35 percent) of R&D credit to 79 percent (100 percent minus 21 percent) of R&D credit.

Crain's: How does the Wayfair decision about "economic nexus" affect business state and local income tax burdens?

Giampapa: With the decision in South Dakota v. Wayfair, Inc. changing the requirement for online and other remote retailers to collect sales tax, many more taxpayers will have the burden of filing and remitting income taxes in additional states. This decision changed the "physical presence" rule to a "substantial nexus" test, thus giving way for more states to require gross receipts to be allocated into a jurisdiction. While the Supreme Court did not provide one standard test for the amount of transactions or dollar amounts, it appears that many states will follow or adopt the same thresholds that South Dakota requires ($100,000 annual sales of goods or services or 200 or more separate transactions).

Strokovskaya: Since the Quill decision in 1992, numerous states have begun implementing economic nexus standards with respect to income taxes. For example, in 2014, New York adopted an economic nexus standard requiring out-of-state corporations to pay the corporate franchise tax if they receive more than $1 million in receipts from New York sources. Following the decision in Wayfair it is expected that states will only be more aggressive in applying economic nexus standards in the income tax context.

Additionally, many companies will have to file sale tax returns in more states. The tax accrual and provision surrounding state taxes will also need to be carefully reevaluated.

Stasaityte: Many businesses are now faced with the possibility of needing to collect sales tax in all 45 states and more than 12,000 local jurisdictions that have sales and use tax—and each state has its own registration requirements, rules of what is taxable and what is exempt, tax rates, filing frequency, etc. This is certainly keeping the in-house accountants and IT specialists busy figuring out how to extract sales data and how to automate the reporting processes. This is particularly burdensome for technology companies, as taxation of digital products and services is still not very well established in every state.

Bublé: For most companies the Wayfair decision will mean a significant increase in both a sales/use and income/franchise tax compliance burden, as well as a potential increase in the business's overall tax costs.

Crain's: What pitfalls should businesses avoid when it comes to the new rules about deductions for meals and entertainment?

Giampapa: With the elimination of the entertainment deduction, taxpayers will no longer receive the benefit of expensing these amounts even when they are directly related to, or associated with, the active conduct of the taxpayer's business. Starting

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after 2025, employer-provided meals will also be considered non-deductible, as long as they are excludable from an employee's income or are considered de minimis fringes.

Strokovskaya: Prior to the TCJA, business meals and entertainment expenses were 50 percent deductible. Now that entertainment expenses are no longer deductible, taxpayers need to separately track expenses that used to be accounted for in a "meals and entertainment" expense account catchall.

A 50 percent deduction for meals is still permitted if the cost is separately charged at an entertainment event. However, if the cost of meals is not separately charged, the expenditure may not qualify as a business meal eligible for the 50 percent deduction.

Stasaityte: For decades, business lunches and baseball tickets were lumped into one category without much thought. Now, more analysis is needed. The lunch is 50 percent deductible, the game ticket is entirely not deductible, and food and beverages purchased during the game are 50 percent deductible (provided they are stated separately on the bill). An office holiday party is neither entertainment nor a meal and it is fully deductible. Meals provided in the office to employees could be fully deductible. Bookkeepers need to be properly trained to recognize the different meal categories and to communicate them to tax preparers.

Bublé: Businesses still need to be mindful of the substantiation rules when it comes to deducting business meals. The business must show that the expense is directly related to the conduct of a trade or business, and the business should have adequate records that document the amount, time, place, and business purpose of the meal's expense.

Crain's: The TCJA includes tax rules for global intangible low-taxed income and a base erosion and anti-abuse tax. When combined with the TCJA's other international provisions, what do these changes mean for taxpayers who report U.S. taxes on international operations?

Bublé: GILTI can be viewed as tantamount to worldwide taxation. In many situations, legitimate deferral of offshore profits is no longer an option. The term "intangible" is a misnomer. Practically all foreign income of the controlled foreign corporation (notably, except for traditional Subpart F income) in excess of a deemed routine return is caught in the GILTI net. It has produced many unwelcome surprises for taxpayers when they are confronted with a tax bill for foreign income that traditionally was not subject to current U.S. taxation.

BEAT applies mostly to larger multi-national corporations. It generally applies only to corporations that have average annual gross receipts of at least $500 million over the past three years. Aggregation rules apply for this purpose. The potential tax of 10 percent (5 percent for 2018) could disturb valid transfer pricing methodologies for outbound payments, such as interest, royalties, etc.

Giampapa: With the enactment of GILTI and BEAT, U.S. individuals will now be required, in many instances, to pay tax on a portion of the current earnings of their foreign corporate holdings. Under GILTI, a U.S. taxpayer owning at least 10 percent of a controlled foreign corporation will be taxed on its current earnings and profits that exceed a notional return on the CFC's depreciable property using the existing Subpart F income provisions in the code.

Taxpayers could be faced with large amounts of tax on earnings that they received through distributions or dividends from the foreign entity. However, a shareholder of a U.S. corporation that owns a foreign corporation will gain a significant benefit under GILTI due to the 100 percent dividends-received deduction available for certain qualifying dividends. In certain instances, this could lead to no income tax due on CFC earnings unless there is Subpart F income.

Strokovskaya: Depending on the structure, the GILTI rules may cause taxpayers to incur a deemed income inclusion for a portion of the active income of the controlled foreign corporation. Taxpayers may also find that tax attributes such as net operating losses and foreign tax credits do not provide the same benefit as they once did prior to the enactment of the TCJA.

Proposed regulations are expected to provide much needed clarity. New, and in some cases modified, tax forms have been provided. In sum, the new rules are complex and interconnected, contain many areas of uncertainty and require the preparation of new forms. U.S. taxation of international operations will be vastly different going forward.

Stasaityte: These provisions were designed with the U.S. multi-nationals like Apple and Google in mind, but have roped in many unsuspecting individuals—only without some of the significant tax advantages available for C corporations. I anticipate that many individuals will be caught off guard by the additional compliance burdens and tax bills. Proper and proactive planning is more crucial than ever.

Crain's: Do you expect the U.S. to be viewed more favorably as a tax-efficient holding company location as a result of numerous corporate tax-advantageous provisions, including low corporate income tax and participation exemptions?

Strokovskaya: A reduction in corporate income taxes with a limited participation exemption will make the United States more attractive from an income tax perspective. However, the United States is not the only country with a relatively favorable corporate tax regime. Non-U.S. taxpayers can only add the U.S. to the list of jurisdictions that have these features.

Stasaityte: The tax reform has certainly made an effort to combat multinationals' flight to tax havens. The new international tax provisions can also be seen as a unilateral response to the international Base Erosion and Profit Shifting Project launched by the Organization for Economic Cooperation and Development.

At the same time, the U.S. has been very stingy on sharing any information with other countries—it did not adopt the so-called Common Reporting Standard, a global agreement to automatically share beneficial owner information with different countries. States like Delaware or Nevada are happy to provide the secrecy and privacy that many foreign investors desire. But when we speak with foreigners wanting to invest in the United States we often find that their primary motivators are not tax-related. They value political and economic stability, as well as investment opportunities above all.

Bublé: The flat federal corporate tax rate of 21 percent is extremely attractive and is among the lowest corporate tax rates throughout the world. If structured properly, state corporate income taxes could be largely eliminated as well.

In addition, the U.S. now competes with patent box regimes offered by other countries, in terms of intellectual property. With the introduction of a deduction for foreign income (including royalties) derived by U.S. C corporations, the federal corporate rate of tax can be reduced to 13.125 percent.

Tax advantages, coupled with an extensive treaty network and a business-friendly environment, have now catapulted the U.S. to the short list of ideal sites for a holding company structure.

Crain's: How does the TCJA impact a company's accounting for income taxes as it relates to the valuation allowance assessment?

Strokovskaya: The TCJA added a layer of complexity to the valuation allowance assessment. The international provisions contained in the TCJA have arguably made tax attributes less valuable. For accounting purposes, taxpayers need to consider whether to establish or increase valuation allowances against deferred tax assets.

For instance, under BEAT, taxpayers pay an incremental tax on modified taxable income above regular taxable income after net operating losses. For a taxpayer with significant NOLs and no regular tax liability, the entire tax payment would consist of the incremental BEAT. If the taxpayer expects to be a BEAT taxpayer in future years and offset regular tax liability with NOLs, is the taxpayer still benefiting from the NOLs or should a valuation allowance be established? Similar questions arise with respect to the impact of other international tax changes enacted under TCJA.

Bublé: A taxpayer may come out of a three-year cumulative loss position due to a large amount of taxable income from deemed mandatory repatriation of foreign earnings. However, this one-time income alone does not warrant the reversal of valuation allowance because VA assessment requires all available evidence to be weighed.

Taxable income in prior carryback years can no longer be considered a source of taxable income to assess the realizability of deferred tax assets because the general two-year carryback was repealed for NOLs arising in a tax year ending after 2017. One the other hand, post-TCJA NOLs are carried forward indefinitely (subject to 80 percent of taxable income limitation) ,while pre-TCJA NOLs can be carried forward for 20 years. As a result, the realizability of deferred tax assets should be assessed separately for these NOLs.