NJBiz

Grin and bear it: Higher taxes on horizon for NJ businesses

By Martin Daks, September 10, 2018 at 3:00 AM - Last modified: September 13, 2018 at 7:43 AM

Business owners across the state breathed a sigh of relief this summer when Gov. Phil Murphy and Senate President Stephen Sweeney reached a budget compromise and narrowly avoided a government shutdown.

As part of the nail-biter deal, Murphy backed down from a plan to hike the state sales tax to 7 percent, but that bit of good news was overshadowed by another part of the horse-trading that will mean higher corporate and individual income taxes.

And if that wasn't enough, changes in the federal tax law — and a new IRS interpretation — could saddle many New Jerseyans with even more financial burdens.

The big news, of course, was the announcement that companies with income above $1 million will generally be hit with a four-year Corporate Business Tax surtax. During the 2018 and 2019 tax years the extra charge will be 2.5 percent, bringing the state's total CBT to 11.5 percent.

That will reportedly give the Garden State the dubious honor of having the nation's second-highest CBT, at least for a while. (Iowa currently holds the top spot, at 12 percent, but the Hawkeye State is planning to drop its rate to 9.8 percent in 2021.) There's a bit of relief, though: New Jersey's CBT surcharge is scheduled to drop one point, to a total 10.5 percent, for the 2020 and 2021 tax years, after which it's supposed to sunset.

Long-term pain

Even then, though, some residents will still have to dig even deeper into their wallets since the new budget will lift the personal income tax rate to 10.75 percent from the current 8.97 percent for people making more than $5 million a year. Short of leaving the state, there's not much they can do about it, according to Paul Graney, a partner in the accounting and advisory firm Marcum LLP, who's also leader of its State and Local tax practice.

"If you have an S corporation (where corporate income, losses, deductions and credits are passed through to shareholders) in New Jersey, you could theoretically try to set up a separate C corporation (which pays its own taxes on profit, and shareholders are taxed on dividend income) in a different, lower-tax state," Graney said. "This way, you may avoid having the business' income flow into your New Jersey return. But it would likely require you to move the business itself, and all its employees, to another state. So many people will probably just grit their teeth and pay the additional tax."

Graney

Residents may be foaming over the new higher tax rates, but another part of the budget compromise avoided the spotlight, even though it could cost more for professional service providers, according to Tom Corrie, a principal at Friedman LLP and director of the firm's State and Local Tax Group.

"Historically, New Jersey receipts from the sale of services were based on the location where they were performed," he said. "But as part of the new budget, effective 2019 the state will implement a market-based sourcing regime for services."

Previously, physicians and other service providers with a New Jersey practice could legally establish personal residency in a low-tax or no-tax state like Florida and set up a company there that provided management services to the New Jersey practice and billed the main business for the activity. "This way, a portion of the revenues could be transferred from New Jersey to Florida, where the business owner would pay lower state income taxes, or even no state income tax," he said.

With the new rules, however, "the receipts are now allocated to the location where the client is located," Corrie added. "So if the client is located in New Jersey, then the revenues are now allocated to New Jersey."

Rubbing SALT in the wound

It's no wonder some Garden State business owners may feel besieged. On top of the state's moves to collect more money from them, changes in the federal tax code under the Tax Cuts and Jobs Act generally limits the federal tax deductibility of SALT, or state and local taxes, to $10,000 — an amount that isn't even equal to the property tax alone paid by many residents here. Unsurprisingly, New Jersey and some other high-tax states have filed a federal lawsuit trying to overturn the provision.

In a bid to provide immediate relief, Gov. Phil Murphy in May signed legislation aimed at allowing taxpayers to donate to a charitable fund established by their municipality, county or school district. In return for their donation, the taxpayer will get a credit on their property tax bill of up to 90 percent of the amount donated. The idea is that New Jersey taxpayers would then be able to claim the donation as a charitable deduction on their federal income tax return, getting around the SALT limit.

But Murphy's law may hit a snag, according to Corrie. "Generally, you can't get a full federal charitable deduction if there's a quid pro quo where the donor gets something in return," he

said. “If I give you money and you give me a tax credit, it’s not really a gift. And there’s a long line of case law that supports this concept.”

The IRS seems to be thinking along those lines, too. On Aug. 23, the U.S. Department of the Treasury and the Internal Revenue Service issued proposed regulations providing rules on the availability of charitable contribution deductions when the taxpayer receives or expects to receive a corresponding state or local tax credit.

“The proposed regulations issued today are designed to clarify the relationship between state and local tax credits and the federal tax rules for charitable contribution deductions,” according to an IRS announcement. “Under the proposed regulations, a taxpayer who makes payments or transfers property to an entity eligible to receive tax deductible contributions must reduce their charitable deduction by the amount of any state or local tax credit the taxpayer receives or expects to receive.”

What if a business owner simply has his or her company purchase their home, and write off the property taxes as a business expense? Corrie put the kibosh on that idea.

“First, you’d have to consider a host of other issues, including the cost of transfer taxes,” he noted. “Then you need to do a thorough cost-benefit analysis and consider whether the transaction may be deemed to be a tax-avoidance scheme, where you’re structuring a deal just to avoid paying taxes. IRS will be looking closely at schemes like these.”

Corrie’s advice: “Consider if you’re taking an aggressive position and then weigh the potential cost of tax representation and litigation. It may be turn out to be more expensive than just paying the tax that you’re trying to avoid.”