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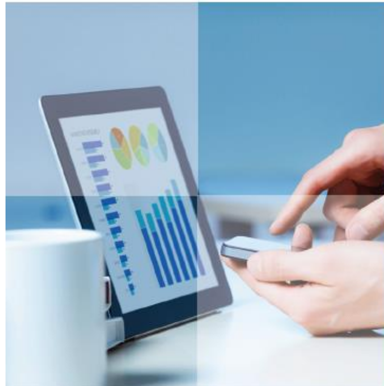

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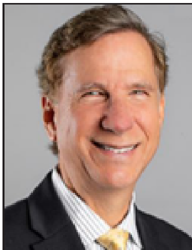
GUEST COLUMN

As Federal Tax Records Simplify, Those for States Become More Complex



Bradford L. Hall

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Having recently completed the first tax season under the Tax Cuts and Jobs Act (TCJA), one of the biggest takeaways is the newly forged schism between federal filings—simplified by Code Sec. 199A and its 20% federal tax deduction for certain qualifying businesses—and their state counterparts, which are no longer federally conformed as they used to be prior to the 2018 tax filing season.

The Internal Revenue Code (IRC) dictates the rules on a federal level, but none of our states adopt the IRC in whole—they instead take pieces, which are then modified or tweaked to suit their unique needs. Even within that practice, the degrees to which states conform to the broad strokes of the IRC vary wildly. Some states automatically conform with updates after a certain time frame, while California, for example, only conforms with the federal tax code in the event of an active vote securing two-thirds of the Legislature.

The little differences from these gaps can quickly add up for people with more complex tax situations—particularly after changes as wide-reaching as the TCJA. Following the current federal code, for example, a person cannot write off any entertainment expenses having to do with their business, whereas prior to the 2018 tax year, they were able to deduct 50%. In California and in most states, these expenses can still be written off so long as they adhere to numerous criteria.

Was food provided as part of an event, or purchased separately? Business meals are still 50% deductible for both federal and state tax filings. The meals can't be too lavish, or the deduction will be disallowed. Who were you dining with, and was business the main purpose? Were you there while the food was being served? If not, was an employee of yours there to represent you and your company?

Even for something as simple as a business meal, one can see that questions and technicalities can pile up all too quickly. What is new this past filing season is all the changes between federal and state tax deductions related to the TCJA, which has created a minefield for CPAs.

Some of the notable examples of the growing schism between state and federal standards include:

- The casualty and theft loss deduction is repealed by TCJA in all cases except a federally declared disaster area.
  - California allows you to take a deduction for casualty or theft losses.
- Entertainment expenses are no longer deductible under TCJA.

- — California allows you to continue to deduct 50% of all entertainment expenses in your business or as an employee business expense.
- TCJA eliminated 100% of employee business expenses on Schedule A.
  - — California allows you to continue to deduct 100% of all employee business expenses on Schedule A.
- TCJA eliminated the requirement to terminate and restart a partnership when there is a greater than 50% change in ownership.
  - — California requires you to file two short-period returns, as well as make new elections, when this change occurs.
- Small business accounting methods are simplified and given a uniform small business exemption ($25 million) from various accounting method requirements (cash method of accounting, 263A unicap, *etc.*) under TCJA.
  - — California may require you to keep separate books for California tax purposes due to differences in accounting method requirements.
- TCJA limits to $10,000 the itemized deduction for state and local taxes paid.
  - — California has not conformed to this change. Thus, the itemized deduction for taxes other than state income taxes is not limited.
- TCJA charitable deduction limit increased maximum of from 50% to 60% of adjusted gross income for federal purposes.
  - — California has not conformed to this increased limitation and remains at 50%.
- The impact on all small business owners (those with taxable income of less than $315,000 for joint filing or $157,500 for single filers) is huge, as they all are eligible for the Code Sec. 199A 20% deduction. For the rest of the businesses which are not C corporations or with income over these thresholds above, their CPAs need to make a determination as to whether or not they qualify for the 20% federal tax deduction.
  - — California has not conformed to this 20% deduction.

These key differences are important for both business owners and CPAs. In particular, accounting firms must see this widening gap as both a challenge to be met and an opportunity for leadership, training and growth.

Firm leaders who seize upon this chance to educate, recruit and retain experts among their staff members will be able to separate themselves from the pack by providing an ever-more-important service for clients as regulations and standards continue to ebb and flow.

In the future, it's likely that this schism will continue to present difficulties for qualifying businesses. Whether state and federal standards begin to conform to one another or grow even farther apart, the fluidity of the regulations will present evolving challenges for taxpayers. As this situation evolves, it will be all the more critical to have a thorough understanding of both sets of regulations—understanding only one or the other may be increasingly costly as time goes on.

In addition to serving as managing director at Hall & Co., Brad Hall specializes in strategic tax planning for high net worth individuals, including corporate owners and executives, closely held corporations, partnerships, LLCs, and trusts.

PAR welcomes guest columns from accounting firm leaders and experts who can provide and advice to leaders in the public accounting profession. Those interested in writing a guest column for PAR should write to Editor Julie Lindy at Julie.Lindy@wolterskluwer.com with the subject line: Guest Column Proposal. ■