ISSUES IN BRIEF

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FEDERAL TAX CONFORMITY -- For many states, including New York, state-level business and personal income taxes are based on the federal tax code, so most states are considering options for responding to the federal Tax Cut and Jobs Act of 2017, or TCJA. The recently adopted New York State budget addressed three general categories of federal tax conformity issues.

Personal income tax decoupling – Without state response, personal income tax liability in 2018 would have increased by up to $1.5 billion, due to the interactions between state tax law and the new provisions of the TCJA. After being initially highlighted by the Empire Center, the Governor proposed in his Executive Budget 30 day amendments, and the legislature approved, the following changes:

- decouple New York's personal income tax (PIT) from the federal $10,000 cap on deduction of state and local taxes (SALT), which would have adversely impacted state taxpayers with more than that amount in real property tax payments, and/or New York City or Yonkers PIT payments.

- allow taxpayers to itemize on their state PIT returns, even if they take the standard deduction on their federal returns.

- maintains the state's standard deduction for single filers, which had been tied to federal personal exemption deduction.

At the same time, the Governor proposed, and the Legislature approved, decoupling from the TCJA's enhancement of the federal child care credit, which would have provided an increased state tax credit as well. This action denied an estimated $500 million in additional tax relief to New York personal income taxpayers.

SALT Cap "Mitigation" – Governor Cuomo has repeatedly claimed that the TCJA's $10,000 cap on deductions for state and local taxes would cost New York taxpayers up to $14 billion in additional federal PIT liability. To partially mitigate this impact, the Governor proposed, and the Legislature approved, two measures intended to maximize federal deductions for state taxpayers:

- An "employer compensation expense tax" (ECET), or payroll tax. The program is optional, with an annual "opt-in" for employers. Employers will pay a payroll tax on each employee's wages over $40,000, at a rate of 1.5 percent in 2019, 3 percent in 2020 and 5 percent in 2021 and thereafter, with these payroll tax payments fully deductible by the employer on their federal corporate taxes. It is expected that employers would reduce payrolls by a similar amount to avoid an increase in their overall costs. Employees would continue to pay the state PIT on their total salary, but would receive a tax credit based on the payroll tax paid by their employer. The intent is that both the employer and employees would have the same after tax income as before federal reforms, while also avoiding a reduction in state tax revenues. However, this only works for employers subject to federal taxation, such as C-corporations, as it would not apply to businesses organized as partnerships and sub-S corporations, or non-profits that don't pay entity-level federal taxes. Presumably, employers would opt into this program as a means to preserve their employee's after-tax income. However, employers will need to consider a number of factors before opting in, including: administrative costs; their willingness and ability to modify payrolls, especially for unionized workers; the impact of wage reductions on other employee benefits, such as pensions, 401K matches; and others.

- new “charitable gift” funds at both the state and local levels, whereby taxpayers making voluntary payments to these funds would receive state PIT or local real property tax credits. The expectation is that these contributions would be federally deductible, and their cost to taxpayers would be offset by tax credits at the state and local level, again leaving the taxpayer no worse off than prior to adoption of TCJA. The state fund could be used for health and education purposes, and tax credits would be available for contributions to existing state health and education foundations. At the local level, school districts, counties and the city of New York would be allowed to create funds to support general spending purposes. The success of these mechanisms is dependent on IRS deductibility of the “contributions,” an outcome doubted by many tax experts.

<u>Business income tax decoupling</u> – The final budget included limited “decoupling” from TCJA provisions that result in increased state-level tax increases for New York’s business taxpayers. The Business Council will be pursuing additional TCJA-related reforms in the post-budget session.

TCJA imposes a one-time federal tax on prior earnings of foreign subsidiaries. Referred to as “transition” or “deemed repatriated” income, the state’s tax department determined that this income falls under a long-standing state deduction for foreign income. The final budget language confirmed this exemption, and added a similar exemption under the state insurance tax and the New York City corporate tax.

However, other conformity issues remain, and left unaddressed will increase state tax liability for many business taxpayers. These include:

- the TCJA imposes ongoing federal taxation of “global intangible low tax income” or GILTI, which is calculated based on a complex formula, and represents income earned abroad but not actually paid to a domestic parent company. Even so, this amount will be added to federal taxable income, and will flow through to state business tax returns, resulting in increased state taxable income for corporations as well as for partnerships, sub-S corporations and other pass through entities.

- the TCJA capped the deduction of business interest expenses at 30 percent of business income, but in exchange allowed a five year period where business could expense, rather than depreciate, most capital investments. New York is already decoupled from federal bonus depreciation, but New York business taxpayers will be subjected to increased state tax liability due to the interest deduction cap.

- while the budget agreement confirmed and/or included an exemption for federal “transition” income under the state corporate franchise and insurance tax, and the NYC corporate tax, it did not address this issue for pass-thru entities (sub-S, partnerships, LLCs) that are shareholders in controlled foreign corporations. A similar exemption should be adopted for these unincorporated businesses under the state and NYC personal income taxes.

- The influx of “transition” income and “GILTI” on state tax returns, and other TCJA provisions, could affect a taxpayer’s status as a qualified New York manufacture, and therefore its eligibility for beneficial tax rates and real property tax credit.

- The TCJA also includes the value of state and local business incentives, such as cash grants, no-cost land, equipment, public infrastructure improvements, and others, in a corporations’ federal gross income; an increase that will flow through to state tax returns as well. Including these values in state taxable income erodes the value of NYS and local incentives, and works at cross purposes to the state’s economic development programs.

There is no current estimate of the increased state business tax liability due to these TCJA provisions, however, these conformity issues will be seen as an economic competitiveness issue for New York and other states. Given the Governor’s focus on avoiding unintended tax increases due to TCJA, these issues should also be addressed during the 2018 legislative session.