NEW YORK RESISTING S.A.L.T. CAP UNDER FEDERAL TAX REFORM

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One of the most headline-grabbing provisions of the Tax Cuts and Jobs Act of 2017 ("T.C.J.A.") is the significant limitations placed on the deductibility of state and local taxes ("S.A.L.T. Taxes") under Code §164. Taxpayers in states that impose relatively high S.A.L.T. Taxes on income and property may experience Federal income tax increases. New York, like other states, is pursuing a workaround to mitigate the impact on its residents.

Under prior law, individual taxpayers were allowed to deduct state and local income and property taxes as itemized deductions under Code §164(a). Further, in lieu of deducting state and local income tax, taxpayers could deduct state and local sales taxes.[1]

Under the new law, the deductible amount of state and local income, sales, and property taxes is temporarily limited to $10,000 per tax year. The limitation applies to tax years 2018 through 2025.[2]

In a report by the New York State Department of Taxation and Finance, entitled the Preliminary Report on the Federal Tax Cuts and Jobs Act (the "N.Y. Report"), the department estimates that the limitations on S.A.L.T. Taxes deductibility will cost New York taxpayers an additional $14.3 billion per year. It further states that the new limitation could threaten the progressivity of the state's tax rates and its ability to provide government services, which could incentivize individual residents to leave the state.

PROPOSED REFORMS TO MITIGATE THE S.A.L.T. TAXES DEDUCTIBILITY LIMITATION

As a response, the N.Y. Report proposes state tax legislation aimed at reducing the state's reliance on personal income tax. Two hotly-debated proposals are

- a state charitable contribution deduction that would allow individual taxpayers to receive a charitable deduction against their S.A.L.T. Taxes for contributions to state-operated charitable funds, and
- an employer compensation expense tax system under which employers would pay a tax on payroll expense and employees would receive a credit against S.A.L.T. Taxes equal to the employer's payroll expense tax.

In February, Governor Andrew Cuomo released the Fiscal Year 2019 Executive

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1 Code §164(b)(5). This election is generally made by taxpayers in states that do not impose income tax.

2 Code §164(b)(6).

Budget legislation (the "F.Y. 2019 Budget") with several amendments to address the impact of the T.C.J.A. on New York residents. The F.Y. 2019 Budget includes proposals for the establishment of state-operated charitable contribution funds and an employer-side payroll tax and employee S.A.L.T. Taxes credit. It includes a provision to require taxpayers to add back the dividends received deduction ("D.R.D.") under Code §965(c) relating to the Federal D.R.D. on deemed repatriated income, as discussed below, to the N.Y. tax base, thereby preventing an unanticipated windfall to affected taxpayers. N.Y. tax law would decouple from the Federal tax law, where necessary, to avoid more than $1.5 billion in state tax increases brought solely by increases in Federal tax law changes.

Charitable Contribution Deduction

The F.Y. 2019 Budget seeks to establish charitable contribution funds that could be used to provide a Federal credit against N.Y. tax to compensate for the limited S.A.L.T. Taxes deduction.

If enacted, N.Y. would establish a state-operated charitable gifts trust fund for a health charitable account and an elementary and secondary education account.[3] The charitable gifts trust fund would be kept separate from other tax revenue funds and could be invested in U.S. or state obligations upon consultation with the director of the budget. The proceeds of this fund could not be transferred to or used by other funds. Funds from the health charitable account would be used exclusively to support primary, preventive, inpatient, routine dental and vision care; hunger prevention; and nutritional assistance services to N.Y. residents. Funds from the elementary and secondary education charitable account would be used exclusively to support elementary and secondary education for N.Y. children. Taxpayers who make contributions to the healthcare or education accounts would be allowed a credit equal to 85% of the amount contributed.

In addition, the governing boards of any N.Y. county or New York City could establish "charitable gifts reserve funds" for the payment of health care and medical assistance expenses. Interest earned and capital gains realized would become part of the fund. At the end of the fiscal year, the municipal funds would be transferred to the general fund or other municipal fund to pay off health care expenses. Taxpayers would be entitled to a 95% credit of the real property taxes imposed by a participating municipal corporation.

Some states already have similar charitable programs in place, and officials in Maryland, Rhode Island, New Jersey, and California have expressed interest in a establishing similar plans. Currently, businesses in New Hampshire can donate to certain school choice scholarship programs that offer a tax credit worth 85% of the contribution. A new bill proposes to expand the program to individuals with respect to certain passive income.

Ultimately, the fate of the charitable contribution funds proposals may depend on the Federal government's response.

While I.R.S. Publication 526 does not allow deductions for contributions from which the taxpayer receives or expects to receive a financial or economic benefit,[4] states

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3 Education and healthcare comprised 60% of state spending in fiscal year 2018.

4 I.R.S. Publication 526.

are arguing that tax benefits are not considered income or value in a traditional sense and therefore the deduction should be allowed. Those in favor of these proposals have stated that historically Federal laws, case law, and rulings have ignored the potential for state tax benefits ons and it would be inconsistent to suddenly declare otherwise.[5]

"Could such a credit be viewed as an abusive tax shelter in light of the avowed intention to circumvent Federal tax law?"

In Chief Counsel Advice 201105010 (the "Advice"), the Chief Counsel decided that a payment of cash to a state agency or charitable organization was a charitable contribution under Code §170 and not a possible deductible tax under Code §164. For a payment to be a Code §170 charitable contribution, the transfer must be a gift without receipt of adequate consideration and made with charitable intent. The intent of a transfer is not charitable if the transferor expects a direct or indirect return. If a benefit is received, the taxpayer may only deduct the contribution amount in excess of the fair market value of the benefit.

The Advice looked at taxpayer contributions to four state tax credit programs that made the taxpayers eligible to receive state tax credits. In a joint tax return, the taxpayers claimed a charitable contribution deduction and were granted state tax credits equal to a percentage of the approved contributions. The taxpayers used certain credits to offset their income tax liability, sold certain credits to other individuals, and carried forward the rest.

The Advice held that the tax benefit of a Federal or state charitable contribution deduction is not the type that negates charitable intent as decided in *Mclennan v. U.S.*,[6] where the court held that a taxpayer is entitled to a deduction even though a donation was made exclusively for obtaining a tax benefit. Instead, the Advice focused on whether the benefit of a state tax credit is distinguishable from the benefit of a state tax deduction. The Advice held that it was not.

Generally, a S.A.L.T. Taxes benefit is treated as a reduction or potential reduction in tax liability and therefore simply a reduction akin to a Code §164 deduction, not akin to a cash payment.

For alternative minimum tax purposes, a deduction for S.A.L.T. Taxes is disallowed under Code §56(b)(1)(A)(ii). As a result, taxpayers subject to the alternative minimum tax frequently opted to make charitable gifts, which generated a state tax reduction through credits. Generally, a "quid pro quo" rule applied that reduced the amount of the deduction received by the value of the benefits obtained.[7]

Historically, taxpayers have never been required to reduce the amount of a Federal charitable deduction by the value of state benefits reaped by the gift, even if the contributions were made to avoid taxes.[8] If a state grants a taxpayer an income tax credit, it is treated as an adjustment to the yet undetermined state income tax liability.[9]

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5 Joseph Bankman, et. al., *Federal Income Tax Treatment of Charitable Contributions Entitling Donor to a State Tax Credit* (January 8, 2018). UCLA School of Law, Law-Econ Research Paper No. 18-02. Available at SSRN.

6 *McLennan v. U.S.*, 23 Cl. Ct. 99 (1991).

7 Treas. Reg. §170A-1(h)(2)(i).

8 *Skirpak v. Commissioner*, 84 T.C. 285 (1985); *Allen v. Commissioner*, 92 T.C. 1(1989).

9 Rev. Rul. 79-315.

Nonrefundable tax credits should be treated as reducing tax detriments and not payments from the state to the taxpayer.[10] This is sometimes referred to as the "Full Deduction Rule" – the amount of the donor's charitable contribution deduction is not reduced by the value of state tax benefits.[11]

A reduction of the state and local tax deduction, coupled with the allowance of a charitable deduction, would appear "tax neutral," except where other provisions, such as the alternative tax come into play. Still, questions remain: Would there be a similar holding where the Code §164 deduction has been reduced by statute? Could such a credit be viewed as an abusive tax shelter in light of the avowed intention to circumvent Federal tax law?[12] If the I.R.S. determines that the credit has the potential for tax avoidance or evasion, taxpayers, promoters, certain facilitating parties (such as exempt organizations and their officers), and material advisors would have obligations to disclose their participation in these regimes. The reporting obligations are further incentivized by a series of substantial penalties or excise taxes.

Others have noted a public policy concern and a fear that these contributions will prevent funds from being allocated to public-school systems, public services, and private charities.

Using Employer-Side Payroll Taxes to Offset Personal Income Taxes

Though the T.C.J.A. significantly limits state income tax deductibility for individuals, an employer's portion of taxes on payroll (referred to as "employer-side payroll taxes") remains deductible.

Payroll taxes are taxes imposed on employers and employees by the Federal government and some states. They generally are calculated as a percentage of the salaries or wages that an employer pays to its employees. Payroll taxes on employees generally are deducted from the employee's wages and withheld and remitted to the Federal or state government by the employer. Payroll taxes on employers are paid from the employers' own funds and are directly related to employing an employee. An example of Federal payroll taxes is the taxes imposed under the Federal Insurance Contributions Act ("F.I.C.A."), which include the Social Security Tax and Medicare Tax. Employees and employers generally pay the same percentage of F.I.C.A. taxes.

The N.Y. Report proposes enacting legislation to establish a new employer compensation expense tax system under which employer-side payroll taxes would be used to raise the state's revenue. The objective of such a system is to rely more on

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10 CCA 201147024.

11 Treas. Reg. §170A-1(h)(2)(i)(B).

12 As reported by CNN Money on January 16, 2018, Governor Cuomo has made explicit statements about the purpose of the charitable contribution funds:

> He urged the state's lawmakers Tuesday to take action now to avoid it [the cap]. . . . In exchange for the charitable contribution, the state would issue the resident a tax credit, although it's not likely to be dollar for dollar, Cuomo said. In addition[,] the resident could deduct his charitable contribution on his federal tax return, since the new federal tax law does not curb charitable deductions. ("How New York's Governor Wants to Get Around the SALT Cap.")

employer-side payroll taxes and less on personal income taxes. The result would mitigate the effect of the individual S.A.L.T. Taxes deductibility limitations. Several variations of an employer compensation expense tax system are discussed in the N.Y. Report, including systems that would be either progressive or flat rate, a system that would apply only to wages above a certain threshold, or an opt-in system. Under each proposal, the personal income tax on non-wage income would be maintained. Thus, for example, interest and dividend income will remain subject to personal income tax.

Under the F.Y. 2019 Budget, if enacted, the proposed employer compensation expense tax system would be optional, requiring the employer to elect to be subject to tax on its payroll expense (referred to as the Employer Compensation Expense Tax or E.C.E.T. system).[13] For the purpose of this new tax, payroll expense is defined as wages and compensation under Federal tax law, including Code §3121 (which defines terms such as wages, employment, and employer under F.I.C.A.) paid to all "covered employees." It would apply only to employees of an electing employer whose wages or compensation exceed $40,000 per year and are subject to payroll taxes. The election must be made by October 1 of a calendar year and will apply to the immediately succeeding calendar year.

Under the proposed system, the employer would pay an E.C.E.T. on its quarterly payroll expense at the following rates:

- 1.5% for 2019
- 3% for 2020
- 5% for 2021 and thereafter

The E.C.E.T. would apply only on payroll expense paid to covered employees during the calendar year in excess of $40,000.

A covered employee would be allowed a credit against the employee's personal income tax equal to the product of the E.C.E.T. paid by the employer and a fraction:

- For 2019, the credit would equal the E.C.E.T. (*i.e.*, the product of the covered employee's wages and compensation in excess of $40,000 during the tax year subject to N.Y. personal income tax and 1.5%) multiplied by the result of one minus a fraction, the numerator of which would be the covered employee's N.Y. personal income tax before tax credits and the denominator of which would be the covered employee's N.Y. taxable income for the tax year.
- For 2020, the credit equal the E.C.E.T. (*i.e.*, the product of the covered employee's wages and compensation in excess of $40,000 during the tax year subject to N.Y. personal income tax and 3%) multiplied by the result of one minus a fraction, the numerator of which would be the covered employee's N.Y. personal income tax before tax credits and the denominator of which would be the covered employee's N.Y. taxable income for the tax year.
- For 2021 and thereafter, the credit would equal the E.C.E.T. (*i.e.*, the product of the covered employee's wages and compensation in excess of $40,000 during the tax year subject to N.Y. personal income tax and 5%) multiplied

13 Amendments to Senate S.7509; Assembly A.9509 (Revenue Article VII Bill), New Part MM §§1, 2.

> by the result of one minus a fraction, the numerator of which would be the covered employee's N.Y. personal income tax before tax credits and the denominator of which would be the covered employee's N.Y. taxable income for the tax year.

If the credit exceeds the taxpayer's tax for the tax year, the excess would be allowed to be carried over to the following tax year or years, with no carryover limitation.

It has been argued that the economic burden of a payroll tax falls almost entirely on the employee, regardless of whether the tax is remitted by the employer or the employee, as the employers' share of the payroll taxes is passed on to employees in the form of lower wages or compensation. Under the F.Y. 2019 Budget's proposed legislation, an employer would not be allowed to deduct from the wages or compensation of a covered employee any amount that represents all or any portion of its payroll expense tax. As a result, it would prevent the employer from shifting the payroll expense tax to the covered employee in the form of lower wages or compensation.

THE T.C.J.A.'S INTERNATIONAL TAX PROVISIONS MAY PROVIDE A (THIN) SILVER LINING

The new tax law introduced significant changes to the Code's international provisions, including a shift toward a partial territorial taxation system. Since the process of computing a taxpayer's New York taxable income begins with the taxpayer's Federal taxable income, it is not surprising that such changes will impact New York. As discussed below, the N.Y. Report discusses three of the international provisions and whether they will be a benefit or detriment to New York's tax base and proposes certain reforms. The F.Y. 2019 Budget proposes amendments that generally follow the report's recommendations.

Transition Tax May Create a Taxpayer Windfall and Indirect State Revenue

Under Code §965(a), a "U.S. Shareholder"[14] owning at least 10% of a certain foreign corporation, known as a "specified foreign corporation,"[15] is required to include as Subpart F Income its *pro rata* share of the specified foreign corporation's previously untaxed foreign earnings. This provision represents a one-time tax on the unrepatriated foreign earnings of specified foreign corporations. It is referred to as the "transition tax" because it applies to previously untaxed foreign earnings to which the new participation exemption for foreign-source dividends does not apply.

Under Code §965(c), the deemed repatriated Subpart F Income is subject to tax at the preferential rates of 8% on cash and cash equivalents and 15.5% on the remaining income. The preferential rates are computed by allowing a D.R.D. for the deemed repatriated income.

For the purpose of computing N.Y. taxable income, Subpart F Income falls into the

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[14] For the purposes of Code §965 and the controlled foreign corporation rules (discussed below), a U.S. Shareholder refers to a U.S. person (*e.g.*, U.S. citizen, resident, or corporation) that owns 10% or more of the total voting stock or total value of the shares of the foreign corporation.

[15] A specified foreign corporation means any controlled foreign corporation (defined below) or a foreign corporation with respect to which one or more domestic corporations is a U.S. Shareholder.

category of "other exempt income"[16] and thus is removed from a taxpayer's N.Y. tax base. As a result, New York is not expected to realize a direct revenue gain from the transition tax. However, the N.Y. Report states that New York will receive an estimated $60 million in revenue attributable to the transition tax because interest expense deductions attributable to the deemed repatriated income generally must be added back to the taxpayer's N.Y. taxable income.[17]

"The N.Y. Report estimates that G.I.L.T.I. could produce approximately $30 million of revenue for New York."

A complicating factor is the deduction used to compute the preferential rates of 8% or 15.5%. In general, taxpayers must add back a D.R.D. taken at the Federal level to their N.Y. tax base. According to the N.Y. Report, it is unclear whether the new deduction can be characterized as a D.R.D. If it is not a D.R.D., it will not be added back to the N.Y. tax base. In such case, the taxpayer will receive a double benefit: the deemed repatriated income will be Subpart F Income – and, thus, subtracted from its N.Y. tax base as other exempt income – and the deduction will have already been removed from the starting point at the Federal level. Thus, the taxpayer will receive both an exemption and a deduction.

The N.Y. Report proposes legislation requiring the add-back of the D.R.D. under Code §965(c). In that manner, although the deemed repatriated income will not be subject to tax in New York, the added-back deduction will prevent a mismatch scenario where the income is not subject to tax but receives a tax benefit (in this case, a deduction).

Following the suggestion of the N.Y. Report, the F.Y. 2019 Budget proposes an amendment to require the add-back of the D.R.D. under Code §965(c).[18]

Current Year Inclusion of Global Intangible Low-Taxed Income May Create Revenue

U.S. Shareholders[19] of controlled foreign corporations ("C.F.C.")[20] must include their *pro rata* share of the C.F.C.'s global intangible low-taxed income ("G.I.L.T.I.") in gross income under new Code §951A, regardless of whether the income is actually distributed to the U.S. Shareholders. Despite its name, G.I.L.T.I. includes more than just C.F.C. income from intangible assets because it is computed by starting with the C.F.C.'s gross income and subtracting a narrow list of excluded income, such as Subpart F Income and dividends to a related person. Corporate U.S. Shareholders are allowed a deduction on G.I.L.T.I. under new Code §250. As a result, the U.S. effective tax rate on G.I.L.T.I. generally is 10.5% through tax years 2025, and 13.175% thereafter when the deduction under Code §250 is reduced and is possibly further reduced by indirect foreign tax credits.

G.I.L.T.I. is similar to Subpart F Income, and in fact under the Code, certain provisions

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16 N.Y. Tax Law §208[6-a(a)].

17 N.Y. Tax Law §208[6-a(d)]. Under this section, interest deductions attributable to other exempt income must be added back to the N.Y. tax base if the attributable interest deductions exceed the other exempt income.

18 Amendments to Senate S.7509; Assembly A.9509 (Revenue Article VII Bill), New Part KK §3.

19 *Supra*, note 4.

20 A C.F.C. is any foreign corporation with respect to which one or more U.S. shareholders are in control of the foreign corporation. For this purpose, control means ownership of more than 50% of the foreign corporations vote or value.

that apply to Subpart F Income specifically apply to G.I.L.T.I. As discussed above, Subpart F Income is specifically characterized as exempt income under N.Y. tax law.[21] However, there is no such exemption for G.I.L.T.I. Thus, unless the law is amended, G.I.L.T.I. will flow onto a taxpayer's N.Y. return as taxable income. The deduction under Code §250 would not be added-back because it is not a dividends received deduction.

The N.Y. Report notes that if no legislative changes are made, New York will tax G.I.L.T.I. If the Code §250 deduction is available, only a portion of the G.I.L.T.I. will be subject to tax in New York (similar to the Federal income tax result).

The N.Y. Report estimates that G.I.L.T.I. could produce approximately $30 million of revenue for New York. Further, the state could consider capturing 100% of G.I.L.T.I. by "decoupling" the state tax law from the Code §250 deduction and thus requiring that it be added back to the N.Y. tax base. In that case, the tax on G.I.L.T.I. at the state level could be as high or higher than the Federal tax.

Tellingly, the F.Y. 2019 Budget amends the definition of "other exempt income" to specifically include the Subpart F dividend under Code §965(a) but does not include a provision to expand the definition to include G.I.L.T.I.[22] Thus, it seems G.I.L.T.I. may remain subject to N.Y. income tax.

New Participation Exemption May Create Revenue

Under the new Code §245A, U.S. corporations will receive a 100% D.R.D. from specified foreign corporations (defined above). According to the N.Y. Report, for New York tax purposes the dividend generally will be characterized as other exempt income under N.Y. Tax Law §208[6-a(a)], and thus it will not be subject to New York corporate income tax. Since New York generally has not been receiving such income (because it has been kept offshore), the participation exemption will not create a significant revenue loss for the state. Nonetheless, the N.Y. Report estimates that the state will experience a small revenue increase from the added-back interest expense deductions attributable to such dividends.[23]

OUTLOOK FOR N.Y. RESIDENTS

While it is clear the T.C.J.A. will impact the state tax liability of some N.Y. residents, it remains to be seen how the state will ultimately respond. The proposals discussed above are still in the early stages of development and will be subject to the lawmaking process, which unavoidably includes the politics of keeping or winning votes.

Thus far, a state Assembly budget resolution has rejected the idea to create statewide charitable funds for healthcare and education but supported the proposal allowing school districts and local governments to create charitable funds. The state Senate approved a one-house budget resolution that did not contain either the proposal for a new payroll tax or the creation of charitable funds. The budget bills will be sent to a joint conference committee for reconciliation.

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21 N.Y. Tax Law §208[6-a(b)].

22 Amendments to Senate S.7509; Assembly A.9509 (Revenue Article VII Bill), New Part KK §1.

23 N.Y. Tax Law §208[6-a(d)].