

January 22, 2018

# Tax Reform and State and Local Taxation

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## Initial New York State Reactions

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### SUMMARY

Pursuant to the federal tax reform enacted in December 2017,<sup>1</sup> individuals are significantly limited in their ability to deduct state and local taxes.<sup>2</sup> As a result, states with high state tax rates have an incentive to change the structure of their tax laws in order to promote greater deductibility on state and local taxes.<sup>3</sup> Moreover, the new federal tax law raises a number of substantial conformity issues.

There have been two recent developments in New York State (“NY” or “State”). *First*, on January 17, 2018, the New York State Department of Taxation and Finance (the “Department”) released a Preliminary Report on the Federal Tax Cuts and Jobs Act (the “Preliminary Report”) (i) outlining options for State tax reform in response to the new federal law and (ii) addressing certain conformity issues. *Second*, on January 18, 2018, NY Governor Andrew M. Cuomo announced a proposal to close what the Governor labelled the “carried interest loophole.”<sup>4</sup>

### DISCUSSION

The Preliminary Report outlines a number of alternative policy options and designs for NY tax reform intended to mitigate the effect of the limitation on the deduction of state and local taxes. Some of these proposals would raise issues under federal tax law and the Internal Revenue Service (“IRS”) might assert that the proposals would not have the intended effect for federal income tax purposes. Moreover, the changes may need to be coordinated with Connecticut and New Jersey; otherwise the taxpayers who reside in New Jersey or Connecticut and work in New York may be disadvantaged by the changes.

**A. PROPOSALS FOR MITIGATING THE LOSS OF THE FEDERAL DEDUCTION OF STATE AND LOCAL TAXES**

**1. Tax Credits for Contributions to “State-Operated Charitable Funds”**

- The Preliminary Report proposes to encourage charitable contributions to the State by providing state tax credits for such contributions.
- Under the proposal, the State could establish “state-operated charitable funds” to deliver public welfare programs and services, as specified by legislation. The Preliminary Report asserts that contributions to such funds would be deductible under federal law, and NY would provide tax credits that would offset some percentage of contributions to the funds that could be used to reduce the donor’s State income tax liability. However, such credits would not be refundable or available for use in future years.
- The Preliminary Report also suggests considering enacting legislation authorizing local governments to encourage charitable giving through local property tax benefits.
- The Preliminary Report does not address whether the IRS would be expected to challenge these charitable deductions.

**2. Payroll-Based Employer Compensation Expense Tax:**

- According to the Preliminary Report, about 80% of personal income tax collected by NY in 2017 was remitted as withholding from employee wages. The Preliminary Report proposes to reduce the State’s reliance on the current individual income tax system and instead adopt a payroll-based employer compensation expense tax system (“payroll-based tax”). Such taxes are imposed on businesses based on a percentage of the salaries that businesses pay their employees. The Preliminary Report suggests this would mitigate the negative impact of the new federal limitation on the deductibility of State income taxes for individuals, because employer taxes on payroll would remain deductible.
- Specifically, the Preliminary Report outlines five different payroll-based tax models for the State to consider:
  - ***A Progressive Statewide Employer Compensation Expense Tax System.*** Under this model, New York would enact a payroll-based tax on employers that could either complement or replace the current income tax and withholding system on wages. The Preliminary Report provides several potential designs for such a tax system, including payroll-based taxes based on the current withholding table or a combination of a progressive payroll-based tax schedule with a wage credit to employees. Under any alternative design, the Preliminary Report states that the personal income tax would be maintained for non-wage income.
  - ***A Flat-Rate Employer Compensation Expense Tax System While Maintaining the Progressive Income Tax System.*** Under this model, New York would adopt a flat across-the-board payroll-based tax on employers, coupled with income tax credits, exemptions or rate reductions for the employees. The Preliminary Report outlines the possible mechanisms and potential issues in implementing a high flat-rate design and a low flat-rate design.
  - ***Target Employer Compensation Expense Tax Above Specified Wage Threshold.*** Under this model, New York would enact a payroll-based tax only to wages that are above a specific threshold, e.g., imposing a tax only on annual wages above \$200,000. The Preliminary Report states that this would help avoid some of the challenges of adopting a broader payroll-based tax system.
  - ***Tax Surcharge on Supplemental Wages.*** Under this model, New York would adopt a flat-rate payroll-based tax that only applies to supplemental wages such as bonuses, commissions and other types of compensation that are not paid at fixed rates or amounts per payroll period. State

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income tax and withholding would be imposed on regular wages not subject to such payroll-based taxes.

- ***Institute an Employer Opt-In Employer Compensation Expense Tax.*** Under this model, employers would have a choice of annually opting-in to the payroll-based tax system, with employees receiving corresponding credits to offset their individual income taxes. The Department suggests that, through the establishment of eligibility criteria and specific obligations imposed on employers opting-in to the system, the State could advance other policy objectives such as labor policies and workforce investment.

### 3. Entity-Level Tax on Pass-Through Entities and Unincorporated Businesses:

- The Preliminary Report outlines two models to shift non-deductible individual income taxes to a deductible business tax on pass-through businesses (or some subset of pass-through businesses), and provide credit for the value of the tax to the owners of the pass-through businesses on their personal income taxes. The Preliminary Report suggests this would mitigate the negative impact of the new federal limitation on the deductibility of state income taxes for individuals because taxes paid in the operation of a trade or business at the entity level would remain deductible.
- ***Tax on the Net Income of Pass-Through Entities and Sole Proprietor Businesses.*** One model proposed is the adoption of a state tax similar to New York City's Unincorporated Business Tax ("UBT").
- ***Tax on the Gross Receipts of Pass-Through Entities.*** The Preliminary Report also describes another model involving the adoption of a state tax based on the gross receipts of pass-through entities. Such taxes would be administered alongside, or as an expansion of, NY filing fees currently paid by LLCs and certain partnerships. Current filing fees impose a fixed-dollar amount that varies based on the level of New-York-source gross income.

## B. FEDERAL CONFORMITY ISSUES

- NY tax law generally conforms to federal law, with certain exceptions. In addition to the broad proposals above, the Preliminary Report also outlines the potential impacts on State revenue and taxpayers in relation to a number of specific changes under the federal tax reform, along with policy options that New York might consider in response to such changes.

### 1. Changes to Business Tax Provisions:

- ***"Deemed Repatriation."*** New York will not conform to the amended section 965(c) of Internal Revenue Code ("IRC"), which imposes a one-time tax on previously untaxed foreign earnings by treating such amounts as Subpart F income, which is currently taxable to certain U.S. shareholders of certain foreign corporations (the "deemed repatriation").
  - The Preliminary Report explains that this deemed repatriation may nevertheless result in higher NY taxes paid due to the State's interest expense deduction disallowance rule. More specifically, the "deemed repatriation" amount itself would not be subject to State taxes because the State provides a statutory exemption for Subpart F income, but NY law requires federal interest deductions attributable to exempt income be added back into the tax base. Therefore, interest expense that had been deducted under federal law that would be allocated to the deemed repatriation amount under existing NY law would be subject to State taxes.
  - Further, the Preliminary Report recommends adopting new State legislation to address uncertainties associated with the State's treatment of deductions that accompany the deemed repatriation provision in IRC section 965(c). According to the Preliminary Report, it is unclear under current NY law whether such deductions would be added back into taxable income. However, because the entire deemed repatriated amount is exempt from State taxes, allowing the federal deductions on such repatriated amounts to further reduce taxable income would result in the taxpayer receiving both an exemption and a deduction. Thus, the Preliminary Report

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recommends that the State should enact a new statutory income add-back for the federal deductions on the deemed repatriated amount in order to avoid what the Preliminary Report describes as a windfall for taxpayers.

- **Global Intangible Low-Taxed Income (“GILTI”).** New York will conform to the newly added IRC section 951A, under which U.S. shareholders of controlled foreign corporations (“CFCs”) must include in income their pro rata share of a CFC’s GILTI (GILTI is a tax on the “excess” return deemed to be attributable to intangibles earned by certain foreign affiliates). While GILTI is treated similarly to Subpart F income under federal law, unlike Subpart F income GILTI is not specifically exempt from State taxation and is thus taxable for NY purposes.
- **Other Business Tax Issues.** The Preliminary Report also analyzes the potential impact on the State caused by a number of specific changes to the federal taxation of businesses in general, including various changes to deductible items, provisions affecting life insurance companies and cost recovery and accounting changes.

### 2. Changes to Personal Income Tax Provisions:

- The Preliminary Report analyzes the potential impacts caused by various changes to the federal personal income tax law, including the increase in the standard deduction, various changes related to itemized deductions and tax credits and 529 Plans. In particular, the Preliminary Report estimates that the overall limitation on the federal deductibility of state and local taxes will cost NY taxpayers an additional \$14.3 billion per year in federal taxes.

### 3. Governor Cuomo’s Carried Interest Proposal:

- The day after the Preliminary Report was released, NY Governor Andrew M. Cuomo announced a legislative proposal to overhaul the State tax treatment of carried interest. According to the press release, the proposed legislation would treat carried interest as ordinary income for State tax purposes and also impose a 17% “Fairness Fix” tax (17% being the difference between the federal tax rate on ordinary income and long-term capital gains for taxpayers with income in the highest bracket). The Governor proposed that this change would be effective only if Connecticut, New Jersey, Massachusetts and Pennsylvania enact legislation having substantially the same effect.

In order for any of the above proposals to become law, a bill must go through the State legislative system and be signed by the Governor.

Questions regarding the Preliminary Report or the Governor’s carried interest proposal may be directed to any member of the Tax Group. Contact information is available on the final page of this memorandum.

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ENDNOTES

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- <sup>1</sup> An act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018 (“Tax Cuts and Jobs Act”), H.R. 1, 115th Congress (2017).
- <sup>2</sup> For more information on the federal tax reform’s impact on individuals, see The Sullivan & Cromwell publication, dated January 8, 2018, titled “U.S. Tax Reform: Individual Taxation,” available at [https://sullcrom.com/siteFiles/Publications/SC\\_Publication\\_U.S.\\_Tax\\_Reform\\_Individual\\_Taxation.pdf](https://sullcrom.com/siteFiles/Publications/SC_Publication_U.S._Tax_Reform_Individual_Taxation.pdf).
- <sup>3</sup> See, e.g., Press Release: *Statement from Governor Andrew M. Cuomo on the Passage of the Senate Tax Bill* (December 2, 2017) (“Eliminating this deduction means that New York will effectively serve as a piggy bank to finance tax cuts for other states.”).
- <sup>4</sup> Press Release: *Governor Cuomo Announces Major Step in Closing Carried Interest Loophole with New “Fairness Fix” to Ensure Justice for New York Taxpayers* (January 18, 2018). Note that the text of the proposed legislation is not available yet.

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