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New York State Tax

Recent Developments in New York State Tax Law Including Tax Provisions in the Recently Enacted Budget

SUMMARY

On March 30, 2018, the New York State ("New York" or "State") legislature passed the State Budget for Fiscal Year 2019 (the "Budget") and Governor Andrew M. Cuomo signed the Budget shortly thereafter.[1] Among other things, the Budget contains New York's legislative response to the federal tax reform enacted in December 2017,[2] including provisions intended to provide New York taxpayers with ways to mitigate the cost of the limitation on state and local tax ("SALT") deductibility for federal tax purposes, as well as certain provisions decoupling State tax law from federal tax law.

In addition, on April 6, 2018, the State Department of Taxation and Finance (the "Department") issued three Technical Memoranda providing guidance on how non-New York residents are subject to New York taxes in the following situations: (i) sales of interests in certain entities that own New York real property and/or shares in a New York residential co-operative; (ii) certain sales of interests in a partnership that holds New York trade or business assets; and (iii) inclusion in New York gross income certain nonqualified deferred compensation for services provided prior to 2009.

DISCUSSION

A. TAX-RELATED PROVISIONS IN THE BUDGET

The Budget generally adopts the legislative proposals that Governor Cuomo had included in the "30-Day Amendments" in February 2018. *First*, the Budget provides for credits against New York State income tax and certain local property tax liability for donations to certain charitable funds. *Second*, the Budget creates a payroll-based tax that employers can opt into, and employees would receive State income tax credits for the payroll taxes paid by such employers. *Third,* the Budget decouples State tax law from federal tax law in several ways, including State tax law's treatment of (i) certain items related to "deemed repatriations," "foreign-derived intangible income" ("FDII") and the global intangible low tax income ("GILTI") provisions under federal tax reform; (ii) alimony, moving expenses and qualified moving expense reimbursements; and (iii) itemized deductions.

1. Charitable Contributions

Under the Budget, taxpayers will receive credits against New York State income tax and certain local property tax liability for contributions to three categories of charitable funds. All such charitable contributions are intended to be deductible against federal income tax, mitigating the cost of the SALT deduction limitation under federal tax reform.

- **State-Operated Charitable Gift Trust Fund**. The first category of charitable funds is a newly created State-operated charitable fund, consisting of a "health charitable account" and an "elementary and secondary education charitable account." For tax years beginning in 2019, New York will provide credits against State income taxes equal to 85% of the amount of contributions to this category made during the *immediately preceding tax year*. Thus, for a calendar year taxpayer, contributions made during the 2018 tax year will be credited against State income tax liability of the 2019 tax year.
- **Pre-Existing Charitable Organizations**. The second category of charitable funds consists of three pre-existing organizations: Health Research Inc. ("HRI"), State University of New York Impact Foundation (the "SUNY Foundation") and the Research Foundation of the City University of New York (the "CUNY Foundation"). Contributions to this category will be creditable against State income taxes in the manner described above for the State-operated charitable fund, but the amount of credits available to all taxpayers is limited—the aggregate amount of contributions eligible for New York State income tax credits, for all taxpayers, is subject to a cap of $10 million for each organization.
- **Local Charitable Funds**. The third category of charitable funds consists of funds that school districts and local governments are authorized to create to finance their own needs. Contributions to this third category provide credits against local property taxes in an amount up to 95% of the contributions made during the 12-month period ending on the day on which the relevant local taxes may be paid without interest or penalties. For example, if the last day to pay property taxes without penalties in 2019 is April 30, then all contributions to local charitable funds between May 1, 2018 and April 30, 2019 will be included. School districts and local governments may choose to set a credit amount lower than 95%, or impose a cap on aggregate contributions received by a particular fund.

Ramifications. While neither the Internal Revenue Service (IRS) nor the U.S. Treasury Department has taken an official position on deductions that would be taken for contributions to charitable funds, the public statements from Treasury officials suggest that there is a significant risk that the IRS would issue guidance purportedly disallowing the deductions.[3] If the IRS were to issue a notice or guidance concluding that such donations would not be allowed, a taxpayer claiming deductions would risk losing such deductions and owing additional taxes along with non-deductible interest on the deficiency and possibly penalties.

2. Optional Payroll Taxes

The Budget creates a new "Employer Compensation Expense Program" ("ECEP") that certain employers can opt into. The ECEP imposes a tax on applicable payroll expenses of electing employers at a rate of 1.5% (increased to 3% in 2020 and to 5% in 2021 and thereafter).[4] Because federal tax law generally does not impose a limitation on deducting business expenses incurred by an entity conducting a trade or business, shifting the cost of State tax on wages from the employee to the employer is intended to mitigate the SALT deduction limitation for individuals.

- **Eligibility**. Only employers that employ "covered employees" can make an election for the ECEP. A "covered employee" is defined as an employee who is subject to New York state withholding and receives more than $40,000 in annual wages and compensation. Individuals resident in another state but employed in New York will be covered employees even though, as described below, these individuals likely will not fully benefit from the tax savings.

- **Election**. In order to be effective, the election must be made by: (1) any member, owner, or other individual with authority to bind the entity or sign returns, if the employer is not a corporation; (2) any officer or manager of the employer authorized to make the election, if the employer is a corporation; (3) unanimous consent of all trustees, if the employer is a trust; or (4) the chief executive officer, if the employer is a governmental entity. The election, if made by December 1 for a particular year, will take effect for the immediately succeeding calendar year. An election made after December 1 will first take effect in the *second* succeeding calendar year.

- **Applicable payroll expenses.** If the election is made, taxes would be imposed on the payroll expense paid to any covered employee during the year in excess of $40,000. The legislation does not permit employers to exclude employees who reside outside of New York from the payroll tax.

- **Employee credit**. The employee will receive a portion of the ECEP tax imposed on his or her wages as State income tax credits.[5] Any unused excess credit will be carried over to the subsequent year.

- **No pass through of ECEP taxes.** The Budget prohibits an employer from deducting from the wages or compensation of an employee any amount that represents all or any portion of taxes imposed under the ECEP. On the other hand, there is no prohibition on taking this tax into account in setting the employee's compensation.

Ramifications. There are several challenges to using payroll taxes as a way to mitigate the impact of SALT deduction limitations. First, employers who elect into the system would have increased compensation costs unless the employer reduces employee compensation levels, which could create an employee relations issue. Second, the ECEP would not benefit employees who live outside of New York, unless their home states allow credit for the amount of payroll taxes collected in New York.

3. Budget Provisions Decoupling the State from Federal Tax Law

a. Clarifications Surrounding the "Deemed Repatriation," FDII and GILTI under Federal Tax Reform

- The Budget provides that "deemed repatriations" of previously untaxed foreign earnings under federal tax reform[6] will be "exempt CFC income" and not taxable in New York State or New York City. However, any federal deductions allowed against the deemed repatriated amounts will be added back to the New York State and City tax base.[7]

- The Budget eliminates federal tax reform's benefit for FDII by adding the federal deductions for FDII back to the New York State and City tax base. FDII is certain income (primarily from intangibles) earned directly by a U.S. corporation from foreign sales or services. Congress created the FDII deduction to provide U.S. companies with an incentive to hold intangibles in the U.S. rather than through foreign subsidiaries.

- The Budget is silent on the inclusion of GILTI into the New York tax base (GILTI is a new category of federal taxable income representing the "excess" return deemed to be attributable to intangibles earned by certain foreign affiliates). Therefore, in accordance with the Department's view as published in its Preliminary Report on the Federal Tax Cuts and Jobs Act,[8] GILTI should be subject to New York taxation under existing New York tax law because GILTI is not specifically excluded from New York taxation, unlike Subpart F income. The 50% deduction for GILTI, however, should also be permitted for New York tax purposes.

- Finally, New York law generally excludes from New York gross income the so-called "Section 78 gross ups" (deemed dividends in respect of foreign tax credits attributable to Subpart F income and GILTI), while federal law also permits a 50% deduction for Section 78 gross ups attributable to GILTI. In order to avoid having both an exclusion and a deduction for the same deemed dividend, the Budget limits the excluded amount of GILTI-related Section 78 gross ups to amounts not already deducted under federal law.

b. Alimony, Moving Expenses and Qualified Moving Expense Reimbursements

- Prior to federal tax reform, alimony was excluded from the adjusted gross income ("AGI") of the payor and included in the AGI of the recipient. Federal tax reform reversed this by taxing the payor on alimony and not the recipient, but the Budget retains the pre-tax reform federal rules. As a result, the payor and the recipient are treated in the opposite manner for federal and New York tax purposes.
- Similarly, prior to federal tax reform, moving expenses and qualified moving expense reimbursements were deductible from a taxpayer's AGI. While both items are now included in AGI under the new federal tax law, the Budget provides that moving expenses and qualified moving expense reimbursements remain excluded from the AGI for New York tax purposes.

c. Itemized Deductions

- The Budget decouples New York State tax laws from federal tax reform's repeal and limitation on itemized deductions for individuals by defining itemized deductions for New York tax purposes "as such deductions existed immediately prior to the enactment of [federal tax reform]" (with certain State-specific modifications).[9]
- In addition, the Budget now allows individuals to choose between State standard deductions or itemized deductions regardless of the election for federal tax purposes, and maintains the State standard deductions for single filers.

B. DEPARTMENT OF TAXATION AND FINANCE GUIDANCE ON CERTAIN ISSUES

A nonresident is subject to New York State income tax only on New York-source income. On April 6, 2018, the Department issued three Technical Memoranda ("TSBs") providing guidance on how nonresidents recognize New York-source income in certain situations.

1. Nonresident's Treatment of Gain or Loss from the Sale of Interests in Entities that Own New York Real Property or Shares in a Residential Cooperative

The first TSB clarifies that a nonresident individual will have New York-source income upon a sale of interests in a partnership or similar entity[10] if the fair market value of the entity's (i) New York real property and (ii) shares in a New York residential cooperative corporation (a "New York Co-Op") equals at least 50% of the value of all of the entity's assets owned for two years or more.[11] In addition, the rules apply to entities in tiered structures and to nonresident or part-year trusts, even if such trusts are otherwise exempt from New York income tax.

2. Nonresident Partner's Treatment of Gain or Loss on Certain Sales or Transfers of a Partnership Interest

The second TSB clarifies that a nonresident partner will have New York-source income upon a sale of interests in a partnership if, from the buyer's perspective, the sale is treated as a purchase of the partnership's assets constituting a New York trade or business.[12] In particular, following an IRS revenue ruling,[13] the Department explains that this rule will apply where a single buyer acquires all of a partnership's interests, causing the partnership status to terminate (because the partnership becomes a disregarded entity for tax purposes).

3. State Tax Treatment of Pre-2009 Nonqualified Deferred Compensation

Federal legislation enacted in 2008 generally limits the ability of taxpayers to defer taxes on compensation where the payor or employer is an entity exempt from U.S. taxation, including a foreign corporation ("nonqualified deferred compensation" or "NQDC"), but NQDC for services provided before 2009 were given a 10-year grandfathering period during which taxpayers could continue the deferral. The grandfathering period is now over and calendar year taxpayers must include their previously untaxed pre-2009 NQDC as part of their 2017 taxable income.[14]

The third TSB provides guidance on how nonresidents will determine the New York-source portion of such deferred compensation attributable to services provided prior to 2009.[15] Different rules apply depending on who is including pre-2009 NQDC in their federal taxable income.

For nonresident individuals, different sourcing rules apply depending on whether the pre-2009 NQDC is related to services performed as an employee or as a business. If services were performed as an employee, the New York-source portion of deferred compensation relating to services performed in a particular year is in proportion to the number of working days in that particular year the employee worked in New York. If services were performed as a business (including sole proprietors, LLCs and partnerships), the New York-source portion is generally determined by reference to the proportion of the net income of the business derived from or connected with New York sources for the taxable year that the services were performed.

Questions regarding the State Budget's changes to New York tax law and the Department's Technical Memoranda 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

[1] New York State Budget for Fiscal Year 2019, S.7509-C; A.9509-C.

[2] P.L. 115-97 (2017). 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.

[3] For example, Treasury Secretary Steven Mnuchin has publicly called the charitable fund proposals "ridiculous" and acting IRS Commissioner David Kautter, testifying before Congress, said that charitable contributions qualify for tax deductions only if the charitable contributions are made for charitable purposes. Jonathan Curry, *Mnuchin Dismisses SALT Workarounds, Charitable Giving Concerns*, Tax Analysts (January 12, 2018), *available at* http://www.taxanalysts.org/content/mnuchin-dismisses-salt-workarounds-charitable-giving-concerns.

[4] Part MM of the Budget.

[5] The credit amount is equal to the product of (a) the amount of payroll taxes imposed on the employee's salary and (b) a percentage equal to 100% minus the employee's effective tax rate.

[6] *See* Section 965 of the Internal Revenue Code.

[7] Part KK of the Budget.

[8] New York State Department of Taxation and Finance, *Preliminary Report on the Federal Tax Cuts and Jobs Act* (January 2018).

[9] Part JJ of the Budget.

[10] The TSB provides that partnerships, LLCs treated as partnerships, S corporations and non-publicly traded corporations with 100 or fewer shareholders are subject to these rules.

[11] TSB-M-18(1)I. Note that, for purposes of the 50% test, the denominator (all assets of the entity) only includes assets that have been owned for more than two years, while the numerator (real property and Co-Op shares) is not qualified by an ownership period. If all assets of the entity have been owned for less than two years, then the 50% test is met.

[12] TSB-M-18(2)I. More specifically, the relevant New York statute applies to a sale or exchange of partnership interests that is "considered subject to the provisions of IRC § 1060." The TSB provides that a sale or exchange is considered subject to § 1060 if: (i) the transferor recognizes a gain or loss on the sale of the partnership interest for federal income tax purposes; (ii) the transferee treats the purchase of the partnership interest as a purchase of partnership assets; (iii) the assets acquired by the transferee constitute a trade or business; and (iv) the transferee's basis in the transferred assets is determined wholly by reference to the transferee's consideration.

[13] *See* Rev. Rul. 99-6, 1999-1 C.B. 432 (providing that a sale or transfer of partnership interest that causes the partnership's status as a partnership to terminate under IRC Section 708(b)(1) is treated by the buyer as a purchase of the partnership's assets).

[14] IRC Section 457A, adopted as part of the Emergency Economic Stabilization Act of 2008. Nonqualified deferred compensation for services prior to 2009 will be includable in gross income in the later of (i) the last taxable year beginning before 2018, or (ii) the taxable year in which there is no substantial risk of forfeiture of rights to such compensation.

[15] TSB-M-18(2)C, (3)I.

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