

March 5, 2018

Tax Reform and State and Local Taxation

Recent State Tax Proposals Relating to the Limitation on State and Local Tax Deductions Enacted by Federal Tax Reform

SUMMARY

Under the recently enacted federal tax reform,¹ individuals and trusts are limited (significantly in some cases) in their ability to deduct state and local taxes (“SALT”).² As a result, states with high state taxes have an incentive to change the structure of their tax laws in order to mitigate the costs of state and local taxes.

In particular, several legislative proposals have been made in California, Connecticut, New Jersey and New York intended to address the limitations on SALT deductibility. This memorandum discusses some of these legislative proposals, with particular focus on three ideas that have received widespread attention: the use of charitable funds, imposition of employer-side payroll taxes on compensation and entity-level taxation on pass-through entities. This memorandum also addresses some changes proposed in New York, California and Connecticut related to the conformity of their state laws to federal tax reform.

DISCUSSION

A. CHARITABLE TRUSTS

One widely discussed suggestion for mitigating the impact of the federal limitation on SALT deductibility is through the creation of “charitable funds,” to which taxpayers could make contributions that would be deductible for federal purposes. The state would then permit state or local tax credits for the contribution made. Government officials in California, Connecticut, New Jersey and New York have announced proposals or introduced bills providing for the creation of such charitable trusts. Although the Internal Revenue Service (“IRS”) has not officially reacted to these proposals, Treasury Secretary Steven Mnuchin has publicly called the charitable fund proposals “ridiculous” and acting Internal Revenue

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Service Commissioner David Kautter, testifying before Congress, stated that charitable contributions qualify for tax deductions only if the contributions are made for truly charitable purposes.³

1. New York

- Governor Cuomo's proposed 30-day amendment to the Budget Bill would create a "charitable gifts trust fund" (the "charitable fund") in the joint custody of the Commissioner of Taxation and Finance and the State Comptroller.⁴
- **Stated purpose of the funds.** The charitable fund would be composed of a "health charitable account" to be used to provide healthcare services to New York residents, and an "elementary and secondary education charitable account" to be used to provide elementary and secondary education in the state. While the charitable fund would be maintained separately from other funds managed by the Commissioner or the Comptroller, "any moneys of the fund not required for immediate use" may be reallocated for another public use at the discretion of the Comptroller.
- **Personal income tax credits provided.** Beginning in 2019, a taxpayer would receive personal income tax credits against New York state income tax in an amount equal to 85% of the contribution made by the taxpayer to the charitable fund during the previous year.
- **Creation of additional charitable funds and property tax credits provided.** In addition to the charitable gifts trust fund above, the proposed amendment also would allow (i) a school district to establish a charitable fund to be used for general education purposes, (ii) any county or New York city to establish a "charitable gifts reserve fund" to be used for payment of healthcare expenses and (iii) any city with a population less than one million, town or village to establish a "charitable gifts reserve fund" with no specified purpose. Taxpayers would receive property tax credits in an amount equal to 95% of the contribution to these additional charitable funds during the current year, subject to certain limitations.

2. California

- Two companion bills are currently under consideration by the California legislature. Together, the companion bills would create the "California Excellence Fund" (the "CEF") to accept contributions to California state for "exclusively public purposes" and allow a state personal income tax credit for contributions to the CEF.⁵ Both bills have been passed in the California Senate and are being considered by the State Assembly. In order to be operative, each bill requires the other to have been passed and be in effect on or before January 1, 2019.
- **Stated purpose of the funds.** From the aggregate amount of taxpayer contributions to the CEF, an amount equal to the aggregate CEF Tax Credit provided would first be transferred to the California General Fund. The remaining amount would be used for a purpose chosen by the taxpayer from a specified list of categories which includes public primary and secondary schools, public universities and state parks.⁶
- **Personal income tax credits provided.** For taxable years beginning after January 1, 2018, the taxpayer would receive a California personal income tax credit of 85% of the amount contributed by the taxpayer to the CEF (the "CEF Tax Credit"). The amount contributed would be intended to be deductible against federal taxable income. While the CEF Tax Credits would be nonrefundable, any excess credits could be carried over for up to six years. After an amendment to the originally proposed bill, the CEF Tax Credits would not be available to corporations.⁷
- **Disregarded entities.** In the case of a taxpayer that directly or indirectly owns an interest in a business entity that is disregarded for tax purposes, the amount of credit allowable that would be attributable to the disregarded entity would be limited to the taxpayer's regular California tax attributable to the disregarded entity.

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3. Connecticut

- On February 6, Connecticut Governor Dannel P. Malloy's FY19 budget adjustment proposal included a proposal which would allow municipalities to create charitable organizations that support town services, in conjunction with a local property tax credit provided to taxpayers for their contributions to such charitable organizations.
- The governor's office has stated that it has language which would be sent to state legislators to consider during the current legislative session, which runs from February 7 to May 9.

4. New Jersey

- A bill currently being reviewed in the New Jersey legislature would authorize municipalities, counties and school districts to create charitable funds. The bill was passed in the New Jersey Senate on February 26 and will be considered by the General Assembly.⁸
- **Stated purpose of the funds.** The charitable funds must have a "specified public purpose" which must be "materially narrower than the general purposes of the local unit."
- **Property tax credits provided.** A taxpayer would receive property tax credits against a specified parcel of property, in an amount equal to 90% of the amount contributed by the taxpayer to a charitable fund. A donation could be credited across multiple parcels of property.
- **Limitations on contributions.** Each charitable fund would also be subject to an "annual donation cap," established prior to the beginning of each fiscal year, that limits the total amount of property tax credits a particular fund can provide for donations. However, a charitable fund that has met the cap would be required to notify the donor and provide the donor 60 days to either redirect the donations elsewhere or rescind the donation. In addition, the ordinance or resolution establishing a charitable fund may also limit the extent to which a large local charitable donation on behalf of an individual property may count against the annual donation cap.

Ramifications. As discussed above, while neither the 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. 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.

B. PAYROLL TAXES

Because federal tax law does not impose a limitation on deducting business expenses incurred by an entity conducting a trade or business, states are exploring the option of mitigating the SALT deduction limitation by imposing a payroll tax on employers. While specific designs could vary, the basic idea is that employers would be able to deduct payroll taxes imposed on the employer and employees would receive offsetting state income tax credits for the payroll taxes collected on the compensation. Only New York state has proposed a concrete plan to date, but other states have publicly discussed the possibility of adopting similar changes.

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1. New York

- Governor Cuomo's proposed 30-day amendment to the Budget Bill would allow certain employers to make an election to be subject to a new "Employer Compensation Expense Tax" ("ECET"), which would impose a tax on applicable payroll expenses at a rate of 1.5% (increased to 3% in 2020 and to 5% in 2021 and thereafter).⁹
- **Eligibility.** Only employers that employ "covered employees" could make an election for the ECET. 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 would be covered employees.
- **Election.** In order to be effective, the election must be made by: (1) the unanimous consent of all owners of the employer, 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.
- **Applicable payroll expenses.** If the election is made, the ECET 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 would receive a credit in an amount equal to the product of (a) the amount of ECET imposed on the employer and (b) the effective personal income tax rate of the employee.
- **No compensation reduction.** The Governor's proposal specifically provides that an employer could not deduct from the wages or compensation of an employee any amount that represents all or any portion of the ECET. For example, if an employee would otherwise be paid \$100,000 with New York State withholding of \$6,000, the cost to the employer would have been \$100,000. Under the proposal, the cost to the employer would be an additional \$5,000 (assuming a 5% ECET rate). This would represent a net increase in compensation costs for the employer.

Ramifications. There are several challenges to using payroll taxes as a way to mitigate the impact of SALT deduction limitations. First, without permitting reduction of compensation for payroll taxes, employers who elect into the system would have increased compensation costs. Second, the above proposal 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.

C. ENTITY-LEVEL TAXATION ON PASS-THROUGHS

Entity-level taxation on pass-through entities is another option that states are exploring to mitigate the limitation on SALT deductions. Like payroll taxes, entity-level taxes would be deductible for federal tax purposes as a business expense, and states could provide for an offsetting state income tax credit for the entity's owners. New York City currently imposes an "Unincorporated Business Tax" (UBT) on pass-through entities, providing limited credits for New York City residents against New York City income tax. To date, only Connecticut has proposed a concrete plan to adopt such a tax statewide, but other states have publicly discussed the possibility of adopting similar changes.

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1. Connecticut

- “An Act Concerning Connecticut’s Response to Federal Tax Reform” is currently under consideration by the Joint Committee on Finance, Revenue and Bonding and was subject to a public hearing on March 2.¹⁰
- **Tax rate.** The legislation imposes a 6.99% entity-level tax on partnerships, S corporations and limited liability companies treated as partnerships for federal income tax purposes.
- **Tax base.** The tax would be imposed on Connecticut-source income recognized by the entity,¹¹ with state-specific modifications to the taxable income base. For example, deductions claimed for depreciable certain business assets¹² would be limited to 80% for the purposes of computing Connecticut adjusted gross income. Net losses may be carried forward indefinitely until they are used.
- **Credits for taxes paid.** Each member of a pass-through entity (i.e. a shareholder in an S corporation or a partner in a partnership) would receive an income tax credit against such person’s pro rata share of the entity-level taxes paid, in an amount equal to 93.01% of such pro rata share of the entity-level taxes. The credit would be refunded if it is in excess of a member’s tax liability in the case of individuals, but carried over indefinitely in the case of corporate members. Corporate members may use these credits against their income taxes without limitations.
- **Reciprocity.** Where applicable, a member of a pass-through entity partnership would also receive credit for entity-level taxation imposed by other states “that the commissioner determines is substantially similar to the tax imposed under this section.”
- **Estimated payments.** As with other typical business-entity taxes, affected pass-through entities would be required to make quarterly estimated tax payments imposed.

2. New York

- While the Preliminary Report on the Federal Tax Cuts and Jobs Act released by the New York State Department of Taxation and Finance discussed the possibility of implementing entity-level taxation similar to New York City’s Unincorporated Business Tax (UBT), there has been no concrete legislative proposal to implement. For more details on the Preliminary Report, see the S&C publication published January 22, 2018.¹³

Ramifications. One key question with respect to this type of plan is reciprocity: if an owner of a pass-through entity resides in a state other than the state imposing the entity-level tax, the entity-level tax would become an incremental cost unless the owner’s home state allowed a reciprocal credit.

D. OTHER LEGISLATIVE PROPOSALS

1. California

- **Increase in the state corporate tax rate.** A bill was introduced to the State Assembly on January 18 to amend the state constitution in order to create a 10 percent tax surcharge on the net income of corporations (including S corporations) exceeding \$1 million, to “share with ordinary California taxpayers the economic gains provided by federal income tax cuts for corporations. . . .”¹⁴

2. Connecticut

- **Nonconformity to federal law.** Governor Malloy’s FY19 budget adjustment proposal also provided that Connecticut would not adopt federal tax changes related to accelerated depreciation and asset expensing in order to avoid revenue loss.

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3. New York

- **Nonconformity to federal law.** Governor Cuomo’s proposed 30-day amendment to the Budget Bill also would decouple New York state tax laws from federal law with regard to the repeal and limitation on various itemized deductions under the federal tax reform.¹⁵ For example, deduction for alimony, qualified moving expense reimbursement and moving expenses would be restored for New York tax purposes, and itemized deductions for New York tax are defined “as such deductions existed immediately prior to the enactment of [the Tax Cuts and Jobs Act].” In addition, the proposal maintains state standard deductions for single filers. These changes may be of limited importance to high income taxpayers in New York due to the state’s preexisting limits on itemized deductions for high earners.
- **Clarifications to the treatment of “deemed repatriations.”** Governor Cuomo’s proposed 30-day amendment to the Budget Bill clarifies that “deemed repatriations” of previously untaxed foreign earnings under federal tax reform¹⁶ would not be taxable in New York state. However, the proposal clarifies that any federal deductions allowed against the deemed repatriated amounts would be added back to the New York state tax base.¹⁷

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 state governor.

Questions regarding state responses to the federal tax reform 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 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).
- 2 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 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 LL of the Amendments to Senate S.7509; Assembly A.9509 (the “30-Day Amendments to the Budget Bill”).
- 5 California Senate Bill (S.B.) 581 creates the “California Excellence Fund” (the “CEF”) and S.B. 227 (“The Protect California Taxpayers Act”) permits the tax credits to be taken for contributions.
- 6 California S.B. 581.
- 7 California S.B. 227.
- 8 New Jersey Senate Bill 1893.
- 9 Part MM of the 30-Day Amendments to the Budget Bill.
- 10 Connecticut Senate Bill 11, titled “An Act Concerning Connecticut’s Response to Federal Tax Reform.”
- 11 See Section 702(a) of the Internal Revenue Code.
- 12 See Section 179 of the Internal Revenue Code.
- 13 The Sullivan & Cromwell publication, dated January 22, 2018, titled “Tax Reform and State and Local Taxation: Initial New York State Reactions,” available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Tax_Reform_and_State_and_Local_Taxation.pdf.
- 14 California Assembly Constitutional Amendment 22, titled “Middle Class Relief Act.”
- 15 Part JJ of the 30-Day Amendments to the Budget Bill.
- 16 See Section 965 of the Internal Revenue Code.
- 17 Part KK of the 30-Day Amendments to the Budget Bill.

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