SALT Alert! 2018-02: Final New York Budget Includes Certain Tax Reform-Related Changes

On March 30, 2018, the New York state legislature passed A. 9509C and S.7509C (the "budget bills"), containing the tax changes approved as part of the Executive Budget for the fiscal year beginning April 1, 2018. The measures have been presented to Governor Andrew Cuomo, who is expected to sign them into law; they include some, but far from all, of the tax changes proposed by the governor earlier this year. The most significant changes, perhaps, are those aimed at addressing certain aspects of federal tax reform enacted as part of Public Law 115-97 (formerly known as the Tax Cuts and Jobs Act). While many of the Governor's proposals were not adopted by lawmakers, the final budget bills include two key changes aimed at providing relief to New York residents in light of the repeal of the uncapped SALT deduction.

Treatment of mandatory repatriation, global intangible low-taxed income, and foreign derived intangible income

The budget bills address the taxation of income required to be repatriated to the U.S. as a result of federal tax reform for both New York State and New York City tax purposes. Both the State and the City have rolling conformity to federal taxable income, so the state was not required to update its conformity to the Internal Revenue Code to capture tax reform. However, the budget bills specifically address the treatment of amounts repatriated under IRC section 965 and foreign derived intangible income (FDII). The final budget does not include an exclusion from entire net income for global intangible low-taxed income or global intangible low taxed income (GILTI). (See below.)

Under New York law, entire net income, minus net investment income and net other exempt income, subject to certain modifications, equals a taxpayer's business income. "Other exempt income" means the sum of exempt Controlled Foreign Corporation (CFC) income and exempt unitary corporation dividends. The budget bills expand the definition of "exempt CFC income" specifically to include amounts required to be included in the taxpayer's federal gross income under IRC section 951(a) by reason of IRC section 965(a) without regard to IRC section 965(c) that are received from a corporation not included in a combined report with the taxpayer. The pre-existing definition of "exempt CFC income" included income required to be included in the taxpayer's federal gross income under IRC section 951(a) that was received from a corporation conducting a unitary business with the taxpayer and was not included in a combined report with the taxpayer. As a result, the exclusion for mandatory repatriation is somewhat broader than current law in that there is no requirement that the taxpayer and the CFC be unitary for the CFC income to be exempt.

Note that under New York law, deductions for interest expenses and other expenses attributable to “other exempt income” are eliminated from entire net income. In lieu of attributing interest expenses to other exempt income, taxpayers may elect to simply reduce investment or other exempt income by 40 percent. The budget bills provide an exception to the rules for underpayment of estimated taxes that call for any increase in a taxpayer’s tax attributable to the expense disallowance provisions or the 40 percent election to be ignored.

Under New York law, entire net income is to be determined without the exclusion, deduction, or credit of various enumerated items. These provisions have been revised for State and City purposes to provide that entire net income shall be determined without (i) the amount of any federal deduction allowed pursuant to IRC section 965(c), and (ii) the amount of any federal deduction allowed pursuant to IRC section 250(a)(1)(A). IRC section 250(a)(1)(A) allows a deduction for 37.5 percent of the FDII of a domestic corporation. Taken together, these changes mean that there is no additional deduction under IRC section 965(c) allowed to New York taxpayers, and New York will not conform to the federal deduction that results in FDII being taxed at a beneficial rate.

The final bills do not address GILTI. As such, GILTI will likely be included in the New York entire net income tax base, and taxpayers will get the benefit of the IRC section 250 deduction. Nor does the final budget provide guidance as to whether GILTI income is afforded representation in the receipts factor apportionment (which, if so represented, would generally dilute the factor). Draft regulations published by the New York State Tax Department of Taxation and Finance provide that income from outside the taxpayer’s regular course of business and/or gain from “unusual events” does not, in general, merit inclusion in the receipts factor; it is unknown whether the Tax Department would categorize GILTI in that sense. To the extent, if any, that GILTI income is not afforded representation in the receipts factor, there may be constitutional and/or generic “distortion” issues implicated. Note that, to prevent a double benefit, the final budget decouples from any IRC section 250 deduction related to IRC section 78 gross-up, since New York’s corporate tax already provides for a full deduction of such gross-up income.

New optional payroll tax

The final budget bills include one of the Governor’s key proposals to blunt the impact of the limitations placed on the state and local tax deduction as part of the Tax Cuts and Jobs Act. Notably, the bills adopt an elective “employer compensation expense program” (hereinafter “payroll expense tax”) that would shift a portion of the individual income tax to a tax on a business entity that continues to be allowed as a deduction to the business for federal purposes. Under the program, an employer required to withhold income tax on wages and salaries paid to its employees may elect to participate in the payroll expense tax with respect to its “covered employees” (those employees receiving more than $40,000 annually in wages and compensation). An election to participate is to be made each year by December 1 to take effect for wages paid beginning with the immediately following January 1.

An electing employer is subject to a tax on the wages paid to each of its covered employees in excess of $40,000 per year at a rate of 1.5 percent in 2019, 3.0 percent in 2020, and 5.0 percent in 2021 and forward. The payroll tax is generally due from the employer at the same time the employer is required to submit withholding payments under the individual income tax, and the new law prohibits the employer from deducting the payroll expense tax from the wages of the employee.

A covered employee is allowed a credit against New York’s personal income tax for a portion of the employer’s payroll expense tax paid with respect to the wages of the employee. The credit, for 2019, is equal to the covered employee’s wages and compensation in excess of $40,000, multiplied by 1.5 percent (the payroll expense tax rate in 2019), times a fraction equal to 1 minus the personal income tax owed by the employee before application of credits divided by the total taxable income of the employee for 2019. For example, an employee receiving $100,000 in salary, having a tax liability of $10,000 before credits and taxable income of $100,000 would be eligible for an income tax credit of $810 [$60,000 x 0.015 x (1 – 10,000/100,000)]. In years after 2019, the relevant tax rate would be substituted in this formula, i.e., 3.0 percent in 2020 and 5.0 percent thereafter.

Charitable contributions provisions

The budget bills also authorize several vehicles to which New York taxpayers can make charitable contributions and in return receive an individual income tax credit for a portion of the contribution. Presuming the arrangement is allowed by the Internal Revenue Service, the contribution would be deductible for federal income tax purposes, in addition to qualifying for a state income tax credit.

First, the budget bills create the “charitable gifts trust fund” with two accounts: a “health charitable account” and an “elementary and secondary charitable account.” The health account is dedicated to the support of services relating to primary, preventive and in-patient health care, dental and vision care, hunger prevention, and nutritional assistance for New York residents. The educational account is to be expended for the elementary and secondary education of children in the state. For tax years beginning on or after January 1, 2019, an individual income taxpayer is allowed a credit against income tax for 85 percent of the total contributed in the immediately preceding tax year to the two accounts in the charitable gift trust fund as well as to Health Research, Inc., the State University of New York research Fund, and the Research Foundation of the City University of New York.

The budget bills also authorize various local school districts, counties, cities and towns to establish certain charitable funds dedicated to specified public purposes, and set forth procedures for taxpayers to credit a portion of the contribution against the property tax due to such local government.

Next steps

While the budget bills provide some certainty as to the treatment of mandatory repatriation, GILTI, and FDII, there are some uncertainties associated with the provisions aimed at reducing the burden on New York residents as a result of the repeal of the uncapped SALT deduction. At this point, it is unclear whether the Internal Revenue Service will ultimately allow federal charitable contribution deductions for donations to state and local charitable contributions funds. Certain Treasury officials have already made comments indicating that such arrangements may not work as intended. Furthermore, it’s unclear how many employers will elect into the payroll tax expense regime.

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