New York State Responds to Federal Tax Reform

Skadden

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If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Stuart M. Finkelstein
Partner / New York
212.735.2841
stuart.finkelstein@skadden.com

Steven J. Matays
Partner / New York
212.735.2372
steven.matays@skadden.com

David M. Rievman
Partner / New York
212.735.3257
david.rievman@skadden.com

Carl R. Erdmann
Counsel / Washington, D.C.
202.371.7127
carl.erdmann@skadden.com

Jeff A. Romero
Associate / Washington, D.C.
202.371.7377
jeff.romero@skadden.com

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

On March 30, 2018, the New York Legislature passed the 2018–2019 Budget Bill (SB. 7509-C/A 9509-C) (Budget Bill), which addresses several provisions of the newly enacted Tax Cuts and Jobs Act (P.L. 115-97) (TCJA) and establishes two new regimes intended to mitigate the impact of the new limitations on the deductibility of state and local taxes. The Budget Bill was delivered to Governor Cuomo for his signature on April 2. As of the writing of this summary, Governor Cuomo has not signed the Budget Bill into law, but is expected to do so shortly.

New York State tax law effectively provides for "rolling conformity" to changes to the Internal Revenue Code (IRC) by using federal taxable income (or, in the case of the personal income tax, federal adjusted gross income) as the starting point for calculating New York State taxable income, subject to certain modifications and exemptions. Accordingly, changes made to the IRC by the TCJA may have significant flow-through effects on the state taxes that New Yorkers pay and the revenues the State collects. The following provides a brief summary of certain significant provisions included in the Budget Bill that relate to the TCJA and highlights certain notable aspects of the TCJA that the Budget Bill does not address.

Transition Tax

The TCJA imposed a new, one-time tax on the accumulated earnings and profits of certain foreign corporations under IRC §965 — the so-called "Transition Tax." Such earnings and profits are taxed as Subpart F income but are subject to a deduction under IRC §965(c).

The Budget Bill clarifies that earnings and profits subject to the Transition Tax are "exempt CFC income," and therefore are not subject to New York State or City corporate tax. However, the Budget Bill did not modify either the interest expense attribution rules related to "exempt CFC income" or the taxpayer election to reduce total exempt income by 40% in lieu of interest expense attribution. Taxpayers should consider the impact of the Transition Tax when considering this annual election. Further, the Budget Bill clarifies that taxpayers are not entitled to the Transition Tax deductions otherwise permitted under IRC §965(c) since the Transition Tax inclusions are considered "exempt CFC income."

In addition, the Budget Bill provides taxpayers relief from underpayment of estimated taxes that could arise from the interest expense attribution related to the Transition Tax. This provision applies to taxable years beginning on or after January 1, 2017 and before January 1, 2018.

Foreign Derived Intangible Income (FDII)

The TCJA added IRC §250, which allows for a deduction of 37.5% (reduced to 21.875% after 2025) of all FDII received by a U.S. corporation in a taxable year. FDII is generally defined as income that is derived in connection with the sale or license of property to a non-U.S. person for foreign use or services provided to any person not located within the U.S.

The Budget Bill provides that the federal FDII deduction is disallowed for purposes of computing New York State and City taxable income.

Global Intangible Low-Taxed Income (GILTI)

IRC §250 also provides a 50% deduction (reduced to 37.5% after 2025) of all GILTI received by a U.S. corporation and any deemed dividend under IRC §78 to the extent such amount is attributable to GILTI, subject to certain limitations. In addition, U.S. shareholders may claim foreign tax credits under IRC §960 (subject to an 80% limitation) for foreign taxes paid with respect to GILTI.

The Budget Bill does not specifically address GILTI. Accordingly, GILTI, and the related deduction allowed under IRC §250 for federal purposes, are taken into account in the determination of New York State and City taxable income. The Budget Bill also limits the subtraction modifications related to IRC §78 gross-up amounts to dividends not deducted under IRC §250.

New Employer Compensation Expense Program

The Budget Bill creates a new "Employer Compensation Expense Program" effective January 1, 2019 that gives employers in New York the option to pay a new payroll tax imposed on the annual payroll expense to "covered employees" in excess of $40,000 per year, at the rate of 1.5% in 2019, and rising to 5% when fully phased in starting in 2021. Covered employees are provided a credit to offset their New York State personal income tax in an amount equal to the payroll tax. Together, these provisions function to allow electing employers to incur a payroll tax expense that is intended to be deductible for U.S. federal income tax purposes while reducing the employee's state tax liability, which may be subject to the TCJA's $10,000 limit. There are a number of factors that should be evaluated by any taxpayer considering making this election, including whether the IRS may challenge the validity of employer deductions.

Charitable Gifts Trust Funds

The Budget Bill establishes two State-operated charitable funds and would allow individual taxpayers to claim a credit against their New York State personal income tax liability equal to 85% of their contributions to such funds in the immediately preceding calendar year. Taxpayers would be eligible to claim such credit for tax years beginning after 2018. The state-operated charitable funds are designed to accept donations for purposes of improving health care and education in New York. The Budget Bill also permits localities to create charitable funds benefiting their localities that would provide property owners a credit of up to 95% of contributions to such funds against applicable property taxes.

This provision of the Budget Bill, like the Employer Compensation Expense Program, is designed to help taxpayers affected by TCJA's $10,000 limit on individual state and local tax deductions. Unlike state and local taxes, charitable contributions remain fully deductible under the TCJA. The deductibility of contributions made to the State-operated charitable funds is uncertain for U.S. federal income tax purposes, and the IRS may challenge the tax treatment of such payments.

At a White House briefing on January 11, 2018, Treasury Secretary Steven Mnuchin criticized proposals similar to the one included in the Budget Bill, stating that it is "ridiculous . . . to think you can take a real estate tax that you are required to make and dress that up as a charitable contribution." Testifying before the Senate Finance Committee in February, Acting IRS Commissioner David Kautter reinforced longstanding principles of tax law and stated that a taxpayer may deduct a charitable contribution if the primary purpose of the contribution is "donative, which is a disinterested and detached interest of generosity."

Open Items and Other Questions

The Budget Bill fails to address several major TCJA provisions, in particular, how the IRC §163(j) limitation of deductible interest operates in light of existing New York State and City limitations on the deductibility of interest expense. Nor does the Budget Bill address how the Transition Tax or GILTI income inclusions impact the corporate tax apportionment factors (*e.g.*, whether GILTI is represented in the receipts factor). The inclusion of GILTI in the New York State and City tax base, without appropriate factor relief, may raise significant constitutional issues.

Finally, the Budget Bill also omits several provisions included in Governor Cuomo's initial proposal, such as the imposition of an "Internet Fairness Conformity Tax" that would have required third-party online "marketplace providers" to collect sales tax on any tangible personal property sold to a New York resident, regardless of whether the seller is located within or outside of the state. Furthermore, the Budget Bill does not include the proposal that would have imposed a 17% surtax on carried interest income and would have treated carried interest income as income from a trade or business for purposes of determining whether it would have been considered to have been earned in New York.