Department of
Taxation and Finance

PRELIMINARY REPORT ON THE FEDERAL TAX CUTS AND JOBS ACT

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PRESENTED TO GOVERNOR ANDREW M. CUOMO

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Introduction

On December 22, 2017, President Donald J. Trump signed into law the Tax Cuts and Jobs Act of 2017,[1] enacting sweeping changes to the federal tax system for both businesses and individuals.

This new federal law will have a disproportionate impact on the tax system and economy of the State of New York – a state that already sends $48 billion more each year to Washington than it receives in federal dollars. In fact, the law appears to target those "donor" states that must raise state and local taxes to make up for this deficit in federal financial support for critical programs and services. Absent changes to New York's tax code, the law's limitations on the deductibility of state and local taxes will cost New York's taxpayers an additional $14.3 billion per year and risk undermining the progressivity of New York's tax system, the investments and services that the State provides for its residents, and the competitiveness of New York's economy over the long term. The elimination of full state and local deductibility rolls back a basic tenet of federal tax law that has been part of the modern federal income tax since it was created in 1913, more than a century ago. States like New York have designed their tax systems according to this principle, which takes state taxes into account before federal taxes. With the transformation of the federal tax system, it is incumbent on New York to consider adjusting its own tax structure accordingly.

Among its most consequential changes, the law permanently cuts the corporate tax rate, lowering the top rate from 35% to 21%. It allows owners of certain "pass-through" entities, like partnerships and limited liability companies, to take a 20% income tax deduction. It moves the country to a territorial tax system, in which only domestic profits are taxed, not income earned abroad. It imposes a one-time "deemed" repatriation tax on foreign earnings at reduced rates. And, it makes a number of changes to other business credits and deductions, including limiting the deductions for interest expenses and research and development expenditures.

For individuals, the law adjusts tax rates across all income brackets, increases the standard deduction, and eliminates personal exemptions. The law also limits or eliminates many itemized deductions, including most significantly a new $10,000 cap on the deductibility of state and local taxes. Most major individual tax relief provisions expire in 2025, after which federal taxes are projected to increase by hundreds of billions of dollars annually absent further action by Congress.

Because the State's income tax system conforms to, and interacts with, the federal system in numerous ways, federal changes will have significant flow-through effects on the state taxes that New Yorkers pay and the revenues the State collects.

The Department of Taxation and Finance presents this preliminary report to the Governor to outline options for State tax reform in response to the new federal tax

[1] Public Law 115-97.

law.[2] Given the far-reaching nature of the law, New York State will need to undertake extensive analysis as it considers how best to respond to its consequential reforms, and the law's impacts will need to be examined over time. In the face of this complex and consequential undertaking, any subsequent changes to the State tax code will be the result of an intensive and measured process.

This preliminary report outlines a series of proposals for consideration and comment, in four Parts.

- Part I outlines a potential proposal for creating additional opportunities for charitable contributions to benefit New Yorkers.
- Part II discusses the policy options for reducing income taxes and shifting instead to a statewide employer compensation expense tax.
- Part III outlines options for a new statewide unincorporated business tax, which would be offset by personal income tax credits for business owners.
- Part IV discusses the impacts of the Act on New York's tax system and outlines potential responses for the State.

The Department recommends that these options be considered in light of these four key State objectives: first, promoting fairness for New York's taxpayers in light of the new limitation on the deductibility of state and local taxes, which negatively impacts New York relative to other states; second, protecting the progressivity of New York's tax system and the investments and services that benefit New Yorkers and beyond; third, protecting and enhancing the competitiveness of New York's economy; and fourth, maintaining New York's revenue base in both the short- and long-term.

I. Charitable Contributions to Benefit New Yorkers

Taxpayers have traditionally been able to reduce their income tax liability by taking deductions for contributions to certain organizations, including charities and Federal, State, local and Indian tribal governments. The new tax law retains and raises the limit on charitable deductions, increasing the contribution limit for 2018 from 50% to 60% of modified Adjusted Gross Income (AGI).

This Part outlines a proposal to build on the expanded federal deduction by encouraging additional charitable giving to the State that would be deductible from federal taxable income for those who itemize their deductions. The State would encourage contributions to State-operated charitable funds by offering a tax credit that would offset some percentage of the contribution.

Many states currently incentivize charitable contributions by providing state tax credits for all or some portion of certain charitable donations in support of public purposes

[2] This preliminary report focuses on the provisions that have the most significant impacts to the State. The Department is undertaking an extensive analysis of the new federal law to catalog all of its impacts on the State and expects that the process will take several months to complete.

and programs. These tax credits typically replace less valuable state tax deductions and complement the federal deductions that remain available for these contributions. For example, many states provide tax credits for donations to support public schools and colleges, with the value of these tax credits ranging from 10% to 100% of the gift.

New York State could establish one or more State-operated charitable funds to receive taxpayers' contributions to support the delivery of programs and services across the state that improve the public welfare, including with respect to healthcare, homelessness and public education. The legislation establishing these new funds would specify the allowable uses of donations to each fund.

To provide an incentive for charitable giving to the new funds, the State would enact a tax credit that would offset some percentage of contributions to the funds made during the taxable year. The credit would be available to reduce a donor's income tax liability, but any credit in excess of that tax liability would not be refundable or available for use in future years. The tax credit would be available to all residents and non-residents who are required to file New York income tax returns.

In addition, the State could consider enacting legislation to authorize local governments to incentivize charitable giving through local property tax benefits.

II. <u>Options for a Statewide Employer Compensation Expense Tax</u>

During his State of the State address on January 3, Governor Cuomo announced that New York would consider the feasibility of restructuring the State's tax code to reduce reliance on our current income tax system and establish a payroll-based employer compensation expense tax system.

While the new tax law limits the deductibility of state income taxes for individuals, employer-side taxes on payroll will remain deductible. Relying more on employer-side payroll taxes and less on personal income taxes could, therefore, allow states to mitigate the negative impacts of the federal law. New York and all other states currently have some form of a state-level payroll tax in place.[3]

In fiscal year 2017, the State's personal income tax (PIT) generated $47.6 billion in revenue, of which $37.5 billion was remitted as withholding from employee wages. Depending on policy design, a new employer compensation expense tax system could be expected to generate billions of dollars annually in federal taxpayer savings while keeping state revenues constant.

This Part presents a number of employer compensation expense tax design options for the State to consider. All of the options discussed below aim to protect or enhance the overall progressivity of the New York tax system and to maintain income taxation

[3] Payroll taxes are calculated as a percentage of the salaries that businesses pay their employees; by contrast, business income taxes are calculated as a percentage of what businesses earn.

of non-wage sources of income so as not shift any of the New York tax burden toward wages from other sources.

A. Create a Progressive Statewide Employer Compensation Expense Tax System

Under this model, New York State would enact a new progressive employer compensation expense tax, which could either complement or replace the current income tax and withholding system on wages. Under any version of this model (including those that eliminate the personal income tax on wages), the personal income tax would be maintained for non-wage income.

i. Design Option 1: Calculate an Employer Compensation Expense Tax Based on Current Income Tax Withholding Tables

One possible design option would be to use the current withholding tax system to calculate a new employer compensation expense tax on wages that employers would be obligated to pay.

New York's income tax withholding system is based on a net wage concept. Annual net wage is calculated as the gross wage reported in Federal Adjusted Gross income (FAGI), reduced by a standard deduction amount and an additional $1,000 per withholding allowance claimed. Taxpayers complete withholding allowance certificates that determine their exemption allowances based on the number of dependent exemptions they are entitled to claim, the number and amount of credits they plan to claim, and the amount of itemized deductions they expect to claim in excess of the standard deduction. In addition, taxpayers with working spouses or multiple jobs are encouraged to use look-up tables to determine if additional withholding will be necessary to meet the income tax due on the combined income. Many taxpayers choose to "over-withhold" – reduce the number of withholding allowances they claim – in order to cover tax liabilities arising from non-wage income, such as interest and dividends, and to reduce the risk of under-withholding penalties.

The Department calculates withholding tables using tax rates that reflect four factors: (1) New York State statutory tax rates, which range from 4.00 to 8.82%; (2) a rate amount for wage earners with net wage above $100,000 to account for the State's itemized deduction limitations above $100,000; (3) a rate amount to account for additional itemized deduction limitations for taxpayers with over $1 million in income; and (4) a rate amount to account for rate recapture/supplemental tax amounts over certain income ranges. Employers use these tables to determine the amount of taxes that must be withheld for each employee based upon the employee's wages and exemption allowances.

Under this design option, employees would continue to calculate exemption allowances based upon their dependent exemptions, credits, and the other information currently included in withholding calculations. Employers would calculate employer compensation expense taxes using new tables that reflect net wages, exemption allowances, and new employer compensation tax rates. The employee could continue to file income taxes as under the current system but receive an income tax credit corresponding to the employer compensation expense taxes paid on his or her wages, which would be used to reduce or eliminate the income tax due on those wages.

ii. *Design Option 2: Implement Progressive Employer Compensation Expense Tax and Eliminate Personal Income Tax on Wages*

A second option would be to levy a progressive employer compensation expense tax that would aim to entirely replace the New York State income tax that is due on taxable wages in the current system. Under this option, wage income would no longer be subject to a personal income tax, which could simplify tax filing for many employees.

Several issues would need to be addressed in designing and implementing such a system. New employer-side compensation expense tax tables would have to be constructed to ensure progressivity while maintaining adequate revenue generation. A progressive tax applied to employees' gross wages could be developed to raise a similar amount of overall revenue as the current tax on wages raises in the aggregate, but the tax levied on any individual employee's wages may not reflect the amount of personal income tax that would be due on those wages in the current system: applying a gross wage concept (i.e., wages in current FAGI) to a single set of progressive employer compensation expense tax rates would not account for many of the factors that are currently used to calculate income tax withholding and liability, such as the number of withholding allowances, marital status, whether the taxpayer itemizes or takes the standard deduction, and other sources of income. For example, the employer compensation expense tax generated for two employees earning $50,000 would differ from the overall tax liability that a married couple earning $100,000 would owe under the current income tax system.

This option would require the development of a method to tax non-wage income that would preserve the revenue currently generated from these sources. Under one possible approach, wages would remain a component of taxable income, so as to maintain the current effective tax rate applicable for non-wage income earned by the taxpayer.

Moreover, if the personal income tax and withholding system for wages is eliminated entirely, the State would need to maintain a withholding system for the prepayment for income taxes due for various sources of non-wage

income, such as retirement fund distributions listed on form 1099-R. Moreover, taxpayers that currently over-withhold to prepay taxes due on their nonwage income would need to be made aware that they might need to make estimated tax payments to avoid under-payment penalties.

iii. *Design Option 3: Implement Progressive Employer Compensation Expense Tax and Provide a Wage Credit to Employees*

A third approach would impose a new employer compensation expense tax using a fixed progressive tax schedule (as described in Design Option 2), but would not exempt wages from the personal income tax. Instead, taxpayers would receive a wage credit against their income tax liabilities.

As in Design Option 2, and unlike the current income tax and withholding system, an employer compensation expense tax would not vary based on factors like filing status or other sources of income. However, depending on the levels and structure of the employer compensation expense tax rates and corresponding income tax reductions, a withholding system could remain in place for employees' remaining personal income tax liabilities, which could still be adjusted to account for factors such as filing status, combined incomes of dual earner families, non-wage income, or additional supplemental taxes that could be imposed at higher incomes.

When employees file their income tax returns, they would claim tax credits that could either correspond directly to the amount of employer compensation expense tax paid on their wages by their employers or be allocated according to some other formula. The net result would aim for overall state revenue generation from employee income taxes and employer-side compensation expense taxes at least comparable to the current system, while reducing federal tax burdens for New Yorkers.

B. Adopt a Flat Rate Employer Compensation Expense Tax While Maintaining the Progressive Income Tax System

One model that New York could consider adopting is a flat across-the-board employer compensation expense tax on wages paid by employers, which could be coupled with income tax reduction mechanisms such as income tax credits, exemptions, or rate reductions. Under this model, which would need to be carefully designed to maintain the tax system's overall progressivity, the progressive personal income tax system would remain in place as in Design Options 1 and 3 in Model A above.

There are some advantages in the design and implementation of this model, relieving employers of the administrative burden associated with applying different tax rates for every employee depending on their salaries. Furthermore, the

process of withholding and filing income taxes could remain virtually unchanged for employees.

i. *Design Option 1: Implement a Flat Employer Compensation Expense Tax at or Below the Lowest Marginal Tax Rate While Maintaining the Progressive Income Tax System*

Under this option, the State would enact a flat rate employer compensation expense tax on wages paid by employers at a fixed rate equal to or below the lowest marginal State income tax rate, which currently is 4%. The employer compensation expense tax would be coupled with income tax relief for employees, which could come in the form of a wage credit, an exemption, or a rate reduction. The value of wage credits or income tax reductions could be calculated to either directly offset the amount of employer compensation expense tax paid by employers on each employee's wages (in which case the credit rate would be set slightly below the employer compensation expense tax rate) or be allocated according to some other formula. Overall, the proposal could provide positive benefits for employees in terms of lower federal income taxes and increased take home pay, while remaining revenue neutral for the State. However, income that is currently taxed at rates above the employer compensation expense tax rate would not benefit from deductibility, meaning that this approach could have fewer economic benefits as compared to the proposals outlined in Section II.A.

One challenge under this option would be ensuring that taxpayers are able to receive the benefit of their income tax reductions on an ongoing basis in advance of the April tax filing. For middle and high-income taxpayers, this could be achieved through adjustments to withholdings. However, there are some employees who ultimately do not owe any state income tax, and others who receive refundable tax credits that reduce their effective tax rates below zero. These employees can elect to have no taxes withheld from their paychecks, so changes to withholding tax tables would not accrue to their benefit. One option to address this issue would be to establish an advance credit program similar to the now-discontinued advance credit option that was available to recipients of the federal Earned Income Credit (EIC).[4] Alternatively, the program could exempt employers from paying an employer compensation expense tax on wages below a set threshold.

ii. *Design Option 2: Implement a Flat Employer Compensation Expense Tax at a Higher Rate While Maintaining the Progressive Income Tax System*

As an alternative, the State could enact a flat rate employer compensation expense tax at a higher rate. In order to maintain the progressivity of the current regime, a system of refundable tax credits could be designed that

[4] The advance credit program was discontinued due to administrative complexity and underutilization.

modulates the progressivity of the combined system. Rather than providing a credit for the amount of employer compensation expense taxes paid, the credit would vary based on income, increasing for lower-income wage earners with effective tax rates now below the employer compensation expense tax rate.

C. Target Employer Compensation Expense Tax Above Specified Wage Threshold

Under this model, New York State would enact a new employer compensation expense tax, but the tax would only apply to wages that are above some specific wage threshold—for example, $200,000 annually, which equates to a $3,846 average weekly wage. No employer compensation expense tax would be applied to wages under the threshold. A corresponding tax credit or exemption schedule would help individuals offset the potential adjustment in salary that might result from a shift in incidence of the tax from employers to their employees.

The limitation on deductibility of state and local taxes makes it harder for New York to effectively tax higher income residents and maintain the progressivity of the New York tax system. By focusing the shift toward employer compensation expense taxes on these high-income New Yorkers, this option could potentially address much of the effect of limiting the deductibility of state taxes paid on wages, and help protect the progressivity of the system. Moreover, focusing on higher salaries could mitigate some of the challenges associated with a broader employer compensation expense tax system, including potential challenges for employers associated with the minimum wage and existing labor contracts.

On the other hand, it is important to note that shifting towards a broader employer compensation expense tax system (beyond high-wage earners) would result in lower federal taxes even for those who take the standard deduction. An income-based proposal could therefore limit the overall benefits of the proposal for New York's residents, while reducing many of the associated challenges.

D. Tax Surcharge on Supplemental Wages

Under this model, New York State would enact a new employer-paid tax surcharge that would apply only to supplemental wages.

State and federal income tax withholding rules differentiate between regular wages and supplemental wages, namely, bonuses, commissions and other types of compensation that are not paid at fixed rates or amounts per payroll period. This option would leverage this distinction to provide differential tax treatment for different types of compensation. Regular wages would continue to be subject to state income taxes, and employers would continue to withhold taxes from their employees' regular wages. Supplemental wages would not be subject to state

income taxes; employers would instead pay a flat rate surcharge on those supplemental wages.

This approach would incorporate a measure of optionality into an employer compensation expense tax system. Employers and employees would be able to calibrate their respective surcharge and income tax liabilities by adjusting the make-up of employee compensation packages to shift wages away from regular wages to supplemental wage packages.

In calendar year 2016, the Division of the Budget estimates that some 12-13% of all wages were supplemental/bonus income. This compensation has traditionally been highly concentrated in the finance sector, which accounts for approximately half of all such income. If this option to tax-advantage supplemental wages were adopted, the number and range of employers who provide compensation through supplemental wages would be expected to increase.

E. Institute an Employer Opt-in Employer Compensation Expense Tax

Under an employer opt-in model, a new employer compensation expense tax would apply only to employers who elect to opt into the system. Those employers who elect to participate would pay an entity-level compensation expense tax, with employees receiving corresponding credits to offset their individual income taxes. This approach would provide flexibility for employers to help their employees adjust to the new federal tax changes.

One version of this model would create a new class of businesses in New York. The new business designation (which for the sake of illustration will hereinafter be referred to as the "A-Business" designation) would not be a substitute for existing corporate forms, such as C corporations, LLCs, and partnerships, and instead would serve as a designation that crosses various corporate forms.

Businesses would be eligible to designate themselves as A-Businesses through an annual election if they meet established eligibility criteria and agree to undertake specific obligations established for such a program. Those obligations would include the adoption of a new employer compensation expense tax system, which could be modeled on any of the design options listed above. Additional obligations of A-Businesses could be designed to advance other state policy objectives relating, for example, to labor policies and workforce investment. Upon assuming these obligations, A-Businesses could then be eligible for program benefits, including income tax relief for their employees, enhanced tax credits under specified programs, and other forms of support.

As with the federal Small Business S-Corporation election available under 26 USC 1362, rules would need to be established to govern the election, revocation, and termination of A-Business status.

F. Issues for Further Study

Form of Income Tax Relief

New York State might consider various options to provide income tax relief to employees in conjunction with a new employer compensation expense tax system. For example, relief could come in the form of a wage credit, a rate reduction, or an exemption. The ultimate construction should be designed to minimize any cash flow issues for taxpayers.

Cash Flow for Employees

Assuming the new model maintains the current income tax system on wages, any income tax relief should be incorporated into income tax withholding tables to allow employees to account for the impact of the income tax relief when calculating their withholding exemption allowances.

Cash Flow to the State

To maintain cash flow, employer compensation expense tax remittance would have to follow the same rules as tax withholding, which is currently 3 days after payroll for the large filers that employ most workers in the State.

Federal Employees

New York State is constitutionally prohibited from levying a tax on the Federal Government. As a result, New York would not be able to collect an employer compensation expense tax on the wages paid to federal employees working in New York State. The Department estimates that those wages currently amount to $300 million annually, which means a potential employer compensation expense tax would generate $12 million less in annual revenue than the personal income tax currently generates. If a new tax structure is coupled with broad-based income tax relief, federal employees would receive a windfall benefit, as their employer would not be liable for the employer compensation expense tax on the wages they earn, but employees could still receive the benefit of income tax relief.

Impact on Labor Costs

Gross wages would be expected to adjust over time to account for a new employer compensation expense tax, in which case labor costs for employers would remain unchanged while the federal tax burden on employees would decrease. To the extent that wages are "sticky" in adjusting downward due to contractual constraints, the minimum wage, or other considerations, these proposals could result in higher labor costs for employers. This risk could be mitigated through a number of policy design options, including phasing in the employer compensation expense tax over time and adopting an employer opt-in approach.

Impact on Local Governments

The salaries of most local government employees are governed by a combination of civil service laws and collective bargaining agreements with the public-sector unions. Without the means to adjust salaries downward, the ability of local governments to finance the additional costs associated with an employer compensation expense tax could be limited.

Treatment of Low-Income Workers

Some employer compensation expense tax design options could apply to wage earners who owe no tax under current law. There are roughly two million filers in the State who are effectively in a 0% tax bracket because their income is below the standard deduction. These taxpayers could be negatively affected if wages adjust downward as a result of the new employer compensation expense tax and they do not receive corresponding income tax relief. This could be addressed through a number of design choices, including structuring the income tax relief as a refundable tax credit or applying the employer compensation expense tax only to wages above a certain threshold.

Tax credit and benefit eligibility

Federal, New York State, and New York City personal income tax credits generally vary based on gross pre-tax taxpayer income. Any measure that reduces gross taxpayer income (even while increasing after-tax income) has the potential to impact individuals' eligibility for these credits. These credits include earned income tax credits, child tax credits, child and dependent care credits, household credits, and real property tax-related credits.

For each of these credits, the range of the above proposals' possible impacts depends on a number of factors, including the calculation of the credit and the individual's income. For instance, if gross pre-tax wages adjust downward as a result of the employer compensation expense tax, taxpayers could generally claim larger federal, New York State, and New York City child and dependent care credits. Likewise, a reduction in FAGI is likely to increase real property tax-related credit amounts.

With respect to earned income tax credits, reduced gross income would be expected to have both positive and negative effects on federal, New York State, and New York City credit calculations. While some taxpayers would be eligible for larger credits, and others would be held harmless, for the lowest income taxpayers the EITC credit amount could be reduced. This adverse outcome could be mitigated through certain design options, such as limiting the scope of the employer compensation expense tax to carve out low-income earners or providing additional refundable credits at the low end of the income spectrum.

It is also important to note that any reduction in gross income could also affect eligibility for a number of governmental and non-governmental benefits and income-based calculations. These include pension benefits, Social Security benefits, and alimony and child support payments.

Residency Issues

New York State will need to study the impact of any proposal on New York residents working in other states, as well as residents of other states working in New York State. Depending on policy design, New York residents working in other states could receive a windfall benefit, and residents of other states working in New York could be penalized. Several design options exist that may obviate these risks.

Personal Income Tax Revenue Bonds

Since 2002, the State Personal Income Tax (PIT) Revenue Bond Program has been the primary financing vehicle used to fund the State's capital program. Legislation enacted in 2001 provided for the issuance of State PIT Revenue Bonds by the State's Authorized Issuers. The legislation requires 25 percent of State PIT receipts (excluding refunds owed to taxpayers) to be deposited into the Revenue Bond Tax Fund (RBTF) for purposes of making debt service payments on these bonds, with the excess amounts returned to the General Fund. In the event that (a) the State Legislature fails to appropriate amounts required to make all debt service payments on the State PIT Revenue Bonds or (b) having been appropriated and set aside pursuant to a certificate of the Director of the Budget, financing agreement payments have not been made when due on the State PIT Revenue Bonds, the legislation requires that PIT receipts continue to be deposited to the RBTF until amounts on deposit in the Fund equal the greater of (i) 25 percent of annual PIT receipts or (ii) $6 billion. Debt service on State PIT Revenue Bonds is subject to legislative appropriation, as part of the annual debt service bill. As of January 15, 2018, New York State had $34.8 billion of State PIT Revenue Bonds outstanding, all of which are secured by 25% of State PIT receipts, net of refunds.

Each official statement relating to the offering and sale of State PIT Revenue Bonds has contained the stated belief of the Director of the Budget that any materially adverse amendment, modification or alteration of, or the repeal of, statutes imposing or related to the State personal income tax imposed pursuant to Article 22 of the Tax Law could have a serious impact on the flow of Personal Income Tax Receipts to the RBTF, the ability of the Authorized Issuers to issue additional State PIT Revenue Bonds and the marketability of outstanding State PIT Revenue Bonds.

The State is committed to maintaining the credit quality of State PIT Revenue Bonds. Accordingly, any proposed law changes that may affect personal income

tax receipts generally should also include legislative changes intended to protect the flow of PIT receipts dedicated to State PIT Revenue Bonds in order to hold harmless the interests of the owners of State PIT Revenue Bonds. For example, the State expects that any reduction in the level of personal income tax collections would be offset by a corresponding increase in the amount of PIT dedicated to the payment of principal and interest on State PIT Revenue Bonds. This percentage can be increased to maintain a comparable flow of PIT receipts flowing through the RBTF, as the remaining 75 percent of PIT receipts today are not dedicated to any other specific purpose or use. In addition, payroll tax revenues could be added as a supplemental source of security for State PIT Revenue Bonds.

III. Options for an Unincorporated Business Tax

The income of certain types of businesses—income derived from profits from a partnership, for example—is "passed-through" to the business's owners, who must pay personal income taxes on that business income. Under the new federal tax law, state and local personal income taxes on this pass-through income would be subject to the new $10,000 deduction limitation. However, taxes paid in the operation of a trade or business at the entity level continue to be deductible as a cost of doing business.

Under the two models outlined below, New York State would shift non-deductible individual income taxes to a deductible business tax on pass-through businesses, or some subset of pass-through businesses, and credit part or all of the value of the tax to the owners of the business on their personal income taxes. This could provide the benefit of preserving deductibility for individuals on certain non-wage income while maintaining revenue levels for the State. Any payments made at the entity level for these taxes could be credited at the individual owner level against personal income taxes.

A. Impose a Tax on the Net Income of Flow Through Entities and Sole Proprietor Businesses.

One option would be to model the tax after New York City's Unincorporated Business Tax (UBT). The NYC UBT is imposed on partnerships, limited liability companies, and other unincorporated businesses such as sole proprietors. The tax also applies to fiduciaries, estates and trusts. The tax is imposed at a rate of 4% on taxable net income allocated to New York City.

The NYC UBT contains exemptions for certain types of business activities, including:

- Taxpayers who purchase and sell property for their own account. This exemption does not apply to broker/dealers, but generally exempts private equity firms and hedge funds from the UBT;

- Taxpayers engaged in holding, leasing, or managing real property for their own account;
- Sales representatives;
- Unincorporated utilities regulated by the State and subject to the City tax on utilities; and
- Associations and publicly traded partnerships treated as corporations for federal income tax purposes and S corporations are subject to the General Corporation Tax.

The NYC UBT also contains credits against tax for individuals and small businesses. Businesses with liabilities of $3,400 or less are allowed a credit for the full amount of the tax, and those with liabilities between $3,401 and $5,400 are allowed a partial credit. New York City residents may claim a credit against their NYC Personal Income Tax for a portion of the UBT payments made as sole proprietors. The amount of the credit varies based on the City resident's taxable income for personal income tax purposes. Part-year residents receive a partial credit.

Design Considerations:

While the credits allowed under the NYC UBT are limited as described above, a State-level UBT could credit up to the full value of the entity-level tax to the owners of the firm against their personal income taxes.

The NYC UBT contains many exemptions that, when enacted, were intended to benefit small businesses. However, those exemptions have grown to encompass a large portion of the New York City tax base, including hedge funds, private equity funds, and real estate management firms, which represent some of the largest business operations in the City. New York State would need to consider whether a statewide UBT should parallel these exemptions and/or provide other exemptions for small businesses, freelancers, and sole proprietors.

Since the NYC UBT is a tax on the net income of a business, it is administered in a similar fashion to an income tax and, therefore, includes much of the complexity inherent in the imposition of income taxes on flow through entity partners and shareholders (such as the complexity of tracking income between tiered partnerships). Challenges associated with administering the NYC UBT include income sourcing and allocation, expense attribution, and the tracking/auditing of payments to partners. Administrative complexity for businesses and the Department would therefore need to be given careful consideration. The State could also consider applying the UBT to another tax base, such as gross receipts, net worth, or paid-in capital.

B. Impose a Tax on the Gross Receipts of Flow Through Entities

Another option to consider in lieu of a UBT is to impose a tax on the gross receipts of pass-through entities similar to the filing fees currently paid by limited liability companies (LLCs) and certain partnerships and the fixed dollar minimum tax currently paid by S corporations.

LLC filing fees are currently imposed on:

- LLCs that are disregarded entities for federal income tax purposes that have income, gain or loss from New York sources.
- Domestic or foreign LLCs or limited liability partnerships (LLPs) that are required to file a New York State partnership return and have income, gain, loss or deductions from New York sources.
- Regular partnerships (not LLC or LLPs) that are required to file a New York State partnership return and have income, gain, loss or deductions from New York sources and had New York source gross income in the preceding year of at least $1 million.

The LLC/LLP fee is a flat dollar amount that varies based on the level of New York source gross income. The fee ranges from $25 for entities with New York source gross income up to $100,000 to $4,500 for entities with New York source gross income above $25 million. Single member LLCs that are disregarded entities for federal tax purposes remit a fee of $25. The fees for regular partnerships with New York gross income over $1 million ranges from a fee of $1,500 for incomes up to $5 million to $4,500 for income above $25 million. The fee is due on the 15th day of the third month following the close of the entity tax year, or March 15th for calendar year businesses.

Imposing a tax based on gross receipts would have the benefit of being administered alongside, or as an expansion of, the current filing fees in place for LLCs, LLPs, single member LLCs, and regular large partnerships that include a large number of partners. The tax would be increased to provide a desired level of revenue and could be remitted on a quarterly basis similar to the NYC UBT. This option would be easier to administer than a UBT, and a similar tax could be imposed on S corporations or administered as an expansion of the current fixed dollar minimum tax paid by S corporations. The structure of the fixed dollar minimum tax is similar to the LLC filing fee. To ease administrative burdens, consideration could be given to excluding sole proprietors and single member LLC's from this proposal.

IV. Federal Conformity Issues for New York State

Federal Conformity Issues for New York State: Personal Income Tax

The federal tax law makes a series of changes to personal income taxes, most of which expire within the next ten years. Those that flow through to New York State, or are expected to have significant revenue impacts at the State level, are outlined below, along with policy options that the State might consider in response to the changes.

A. Increasing the Standard Deduction

Previous Federal Law:

Taxpayers who do not elect to itemize deductions can reduce their FAGI using the standard deduction, which varies based on filing status. The amount of the deduction is indexed annually for inflation using the 12-month change in CPI-U. The value of the standard deduction for tax year 2017 was as follows:

2017 Federal Standard Deduction	
Filing Status	*Amount*
Single:	$6,350
Married Filing Joint:	$12,700
Head of Household:	$9,350

Approximately 6.3 million New York taxpayers (66%) claim the federal standard deduction.

New Federal Law:

The new federal law increases the value of the standard deduction for each filing status, nearly doubling the 2017 amount. In addition, the new deduction amounts will be annually indexed using chained CPI-U, which is generally considered a less generous measure of inflation. The new standard deduction amounts, effective for tax year 2018, are as follows:

2018 Standard Deduction	
Filing Status	***Amount***
Single	$12,000
Married Filing Joint	$24,000
Head of Household	$18,000

Impact to New York:

New York State tax law requires taxpayers who have claimed the standard deduction on their federal income tax return to also claim the standard deduction on their state return. A higher federal standard deduction will lead fewer taxpayers to claim itemized deductions on their federal returns. As a result, the State will have more taxpayers claiming the standard deduction and fewer itemized deductions overall. Approximately 8.1 million taxpayers (78%) claimed the state standard deduction in 2015.

Beginning January 1, 2018, the State's standard deduction will be considerably lower than the new federal amounts:

	2018 Federal Standard	*2018 NYS Standard*
Filing Status	*Deduction Amount*	*Deduction Amount*
Single	$12,000	$8,000
Married Filing Joint	$24,000	$16,050
Head of Household	$18,000	$11,200

The federal tax eliminates or imposes new limitations on many itemized deductions that are addressed later in this preliminary report; New York State conforms to most federal income tax provisions, so these changes flow through to New York returns. The State could raise the state standard deduction to offset the loss of itemized deductions on state income tax returns due to federal conformity rules. The Department estimates that increasing the standard deduction by $500 for joint filers ($250 for singles) would cost the State approximately $100 million. Aligning the standard deduction more closely with the new federal levels would have a more substantial revenue impact.

Absent any legislative changes, the State would generate approximately $44 million in additional revenue from the increase in the federal standard deduction: taxpayers who previously claimed itemized deductions would be taking the higher federal standard deduction and, thus, be required by state law to claim the state standard deduction. The State could consider eliminating the requirement that taxpayers may only itemize deductions on their New York return if they itemize on their federal return.

B. Eliminating Personal Exemptions

Previous Federal Law:

Taxpayers could reduce their taxable income using personal exemptions available for the taxpayer, spouse, and any dependents. The value of each exemption was indexed for inflation and was worth $4,050 in 2017. For example, the taxable income for a family of four could be reduced by up to $16,200. Personal

exemptions were phased out for taxpayers with AGI over $261,500 ($313,800 for joint filers).

Approximately 17.5 million personal exemptions were claimed in New York in 2015.

New Federal Law:

The new federal law temporarily eliminates the deduction for personal exemptions.

Impact to New York:

New York offers state dependent exemptions that can be used to reduce adjusted gross income for state tax purposes. However, the state exemption can be claimed only for dependents, not for taxpayers and spouses. In 2018, the state dependent exemption is equal to $1,050.

Federal suspension of personal exemptions is not expected to impact the State's dependent exemption. State Tax Law only refers to the definition of an eligible dependent, which is unchanged under the new federal law. Therefore, taxpayers may still reduce their New York Adjusted Gross Income (NYAGI) by $1,050 for each dependent claimed.

However, suspension of federal personal exemptions will have a direct impact on the availability of the state standard deduction for single filers. Under current state law, a taxpayer is eligible for the standard deduction for single filers only if the individual "*is not married nor the head of a household nor an individual whose federal exemption amount is zero*…." This language is intended to preclude joint filers, head of household filers, and taxpayers that are claimed as dependents on other taxpayers' returns from claiming the single filer deduction ($8,000 for 2018). Absent a state statutory change, single taxpayers will be required to claim the lower deduction intended for dependent filers ($3,100 in 2018). Approximately 5.2 million taxpayers could see their state tax liabilities increase by $840 million in the aggregate.

C. Enhanced Child Tax Credit (CTC)

Previous Federal Law:

Taxpayers with a qualified child under the age of 17 were eligible for a maximum Child Tax Credit of $1,000 per child. The amount of the credit was phased out as income exceeds $75,000 ($110,000 for joint filers). Any portion of the credit that exceeded federal liability could be refunded to the taxpayer. Approximately 1.1 million New York taxpayers claimed $1.3 billion in federal CTCs in 2015.

New Federal Law:

The new law enhances the CTC by increasing the maximum credit to $2,000, while increasing the refundable portion to $1,400 per qualifying child. In addition, the income phase-out threshold is increased to $200,000 ($400,000 for joint filers), significantly expanding the number of families eligible to claim the credit, reducing its progressivity. The new law also expands refundability of this credit by lowering the refundability phase-in threshold from $3,000 to $2,500 and also adds an additional nonrefundable $500 credit for other dependents aged 17 and over.

Impact to New York:

The Empire State Child credit (ESC) is available to resident taxpayers with children ages 4-16 and is equal to the greater of $100 times the number of children who qualify for the federal child tax credit or 33% of the allowed federal child tax credit. Approximately 1.5 million state taxpayers claimed the ESC in 2015 for a combined benefit of $647 million.

Increasing the federal credit and broadening the income thresholds will flow through to the calculation of the ESC credit, resulting in more and higher tax credit claims by state taxpayers. The new $500 nonrefundable federal credit for other dependents would not flow through to the ESC credit. Absent any legislative changes, the State is expected to see a revenue decrease of approximately $500 million.

The State may choose to decouple from federal law and provide a stand-alone ESC credit. This would preserve the current benefits allowed to New York State taxpayers, the progressivity of the credit, and tax revenues to the State.

D. Limitation on Itemized Deductions

Previous Federal Law:

The overall value of itemized deductions (excluding medical expenses, investment interest, and casualty, theft or gambling losses) was limited by 3% of each dollar that a taxpayer's income exceeds $267,000 (or $320,000 for joint filers). For example, taxpayers who file a joint return reporting combined income of $400,000 are required to reduce their itemized deductions by $2,400 ($400,000 - $320,000 = $80,000 x 3% = $2,400).

New Federal Law:

The law would eliminate the 3% limitation on itemized deductions, thereby increasing the total amount of itemized deductions allowed under federal law.

Impact to New York:

New York itemized deductions are calculated based on the deductions allowed on a taxpayer's federal itemized deduction schedule. Taxpayers must then add or subtract certain deductions allowed or disallowed under state law. New York also applies an additional statutory deduction limitation for certain high-income taxpayers. This deduction limitation varies according to the taxpayer's NYAGI and filing status. Itemized deductions for taxpayers with NYAGI in excess of $100,000 ($200,000 for joint filers) are reduced by up to 25%. All taxpayers with NYAGI above $475,000 must reduce their deductions an additional 25%, with the overall limitation equaling 50% for taxpayers with NYAGI above $525,000. If NYAGI is more than $1,000,000, but less than $10 million, the New York itemized deduction for charitable contributions is limited to 50% of the federal deduction. Taxpayers with NYAGI above $10 million may only claim 25% of their federal deduction for charitable contributions.

Elimination of the 3% federal deduction limitation will increase the base amount for New York itemized deductions, decreasing state revenues by approximately $36 million. However, this revenue impact will be offset by the likelihood that total itemized deductions are expected to decrease due to the limitations on and repeal of certain deductions under the new federal law.

New York State could choose to decouple from the new federal law and retain the 3% limitation. Alternatively, the State could take no action, since the current state limitations would still apply.

E. Mortgage Interest Deduction

Previous Federal Law:

Interest paid or accrued during the taxable year on acquisition indebtedness up to $1 million or home equity indebtedness up to $100,000 could be claimed as an itemized deduction, with certain limitations. A qualified home mortgage loan included any loan that is secured by a taxpayer's main home or second home, including a house, condominium, cooperative, mobile home, boat, or similar property.

Taxpayers could also deduct qualified mortgage insurance premiums, paid under a mortgage insurance contract issued in connection with home acquisition debt. Mortgage premiums are not deductible for taxpayers with income over $109,000.

New Federal Law:

The new federal law lowers the maximum value of mortgages for which mortgage interest payments are deductible to $750,000 for acquisition indebtedness incurred

after December 15, 2017, and suspends the deduction for mortgage insurance paid or accrued for home equity debt.

Impact to New York:

The amount that taxpayers can claim on their federal return for mortgage interest deductions is included in the base amount for purposes of calculating New York State itemized deductions. Since this new limitation is prospective only, it will have a minimal impact on state revenue in the near term.

Nevertheless, New York could choose to decouple from federal law, thereby retaining the current interest deduction of home acquisition indebtedness up to $1,000,000 and home equity indebtedness up to $100,000 with respect to both principal and secondary residences.

F. State and Local Tax Deductions at the State Level

Previous Federal Law:

Any state and local taxes paid during the taxable year could be claimed as an itemized deduction on a federal return. State and local taxes include:

- State and local income taxes (i.e. taxes withheld or estimated payments made during the taxable year);
- State and local general sales taxes (which may be claimed only in lieu of income taxes);
- Real estate taxes;
- Personal property taxes; and
- Other taxes including foreign income, war profits, and excess profits taxes.

Federal Itemized Deduction	Number of NY Taxpayers	Amount Claimed
Total Taxes Paid	3,320,000	$73.6 billion
State & local income taxes	2,921,000	$51.7 billion
Real estate taxes	2,394,000	$20.9 billion

Source: IRS, Statistics of Income Division. SOI Tax Stats – Historic Table 2 State Data Tax Year 2015

New Federal Law:

The new federal law caps the aggregate itemized deduction for state and local taxes, including property taxes, at $10,000 ($5,000 for married taxpayers filing separate returns).

Property and sales taxes paid in carrying on a trade or business (i.e., those presently deductible when computing income on an individual Schedule C, Schedule E, or Schedule F) are not impacted by this provision.

Impact to New York:

The new federal limitation on state and local tax deductions is expected to cost taxpayers in New York an additional $14.3 billion per year in federal taxes.

All state and local taxes claimed as an itemized deduction on a federal return are included in the base amount for the purposes of calculating New York State itemized deductions. Because New York requires state itemized deduction calculations to start with the deductions claimed on the companion federal return, the new $10,000 federal cap on state and local tax deductions will substantially lower the amount of itemized deductions claimed at the state level. Absent any change, the state would see a revenue increase of approximately $400 million.

New York State could consider decoupling from the new federal law, effectively restoring current deductibility at the state level. This would require taxpayers to complete a separate Schedule A to calculate state itemized deductions.

G. Personal Casualty Loss Deduction

Previous Federal Law:

Losses sustained during the taxable year that are not compensated by insurance or otherwise could be claimed as an itemized deduction on a federal return. Aggregate net casualty losses were deductible to the extent that they exceed 10% of adjusted gross income.

New Federal Law:

The new federal law would only allow deductions for personal casualty losses attributable to a federally declared disaster area.

Impact to New York:

Federal deductions allowed for personal casualty losses are included in the base amount for the purposes of calculating New York itemized deductions. In tax year 2015, 3,300 State income taxpayers claimed a combined total of $114 million in personal casualty loss deductions. Absent any legislative changes, this provision is expected to have a minimal revenue impact at the state level.

While the federal law preserves the deduction for losses incurred in federally declared disaster areas, taxpayers will lose the ability to write off other losses, such as those due to fire and theft and losses incurred in state declared disaster areas. Policymakers may consider decoupling from these federal provisions and retaining the full deduction for New York State taxpayers. This would require taxpayers to complete a separate Schedule A to calculate the state itemized deduction.

H. Medical Expense Deduction

Previous Federal Law:

Unreimbursed medical and dental expenses in excess of 10% of adjusted gross income could be claimed as an itemized deduction on a federal return. Approximately 435,000 New York taxpayers claimed $4.5 billion in federal medical expense deductions in 2015.

New Federal Law:

The bill temporarily expands the medical expense deduction by lowering the threshold for deducting medical expenses to 7.5% of adjusted gross income for all taxpayers. The lower threshold will only apply for taxable years 2017 and 2018.

Impact to New York:

Federal deductions allowed for medical expenses are included in the base amount for the purposes of calculating New York itemized deductions. Approximately 372,000 New York itemizers deducted $4.3 billion in medical expenses on their 2015 state income tax returns. Absent any legislative changes, this provision is estimated to reduce state revenues by approximately $25 million for tax years 2017 and 2018.

To preserve revenue, the State could decouple from the new federal law and retain the higher 10% income threshold for medical expenses. Since the lower 7.5% threshold is only effective for tax years 2017 and 2018, the State would need to consider whether to decouple only for this period or on a permanent basis.

I. Alimony Deduction

Previous Federal Law:

Alimony payments were generally treated as taxable income to the recipient spouse and could be deducted from income of the payor spouse.

New Federal Law:

The new federal law no longer allows alimony payments to be deducted by the payor spouse. Therefore, the tax would be incurred by the payor and no longer deemed taxable to recipient spouse. This provision aligns with the treatment of child support payments under current law.

Impact to New York:

The State currently conforms to the federal treatment of alimony payments, which were previously deemed taxable to the recipient spouse. Approximately 20,000 taxpayers claimed alimony income on their state income tax return, for a total of $584 million in payments received in 2015. Absent any legislative changes, the state tax will now be incurred by the payor spouse. This change is expected to have a minimal revenue impact at the state level.

J. Moving Expense Deduction

Previous Federal Law:

Taxpayers could claim an above-the-line deduction for moving expenses incurred in connection with a change in place of employment, subject to a minimum distance requirement and full-time employment status. Approximately 33,000 New York taxpayers claimed $113 million in federal moving expense deductions in 2015.

New Federal Law:

The new law repealed the above-the-line deduction for moving expenses other than expenses incurred by members of the Armed Forces of the United States, which remain deductible.

Impact to New York:

New York's treatment of moving expenses conforms to federal law. This provision is expected to have a minimal revenue impact at the state level. However, the State could consider decoupling from federal law to preserve deductibility for New York taxpayers.

K. Miscellaneous Deductions

Previous Federal Law:

Certain expenses, such as hobby expenses, deductible investment expenses from pass-through entities, investment fees and expenses, unreimbursed business expenses incurred by an employee, and tax preparation fees, could be claimed as itemized deductions on a federal return to the extent that they exceed 2% of adjusted gross income.

Federal Itemized Deduction	Number of NY Taxpayers	Amount Claimed
Total 2% Miscellaneous Deductions	1,300,000	$10.5 billion
Unreimbursed Business Expenses	1,100,000	$8 billion
Tax Preparation Fees	900,000	$450 million
Other Miscellaneous	500,000	$5.6 billion

Source: IRS, Statistics of Income Division. SOI Tax Stats – Historic Table 2 State Data Tax Year 2015

New Federal Law:

The law temporarily repeals all miscellaneous deductions currently subject to the 2% floor.

Impact to New York:

Miscellaneous deductions subject to the 2% floor are included in the base amount for the purposes of calculating New York itemized deductions. Approximately 970,000 taxpayers claimed a total of $11.5 billion in miscellaneous deductions on their 2015 New York State income tax returns. Absent any legislative changes, eliminating these deductions would generate an additional $281 million in state tax revenue.

The State could consider decoupling from the new federal law for some or all of the miscellaneous deductions that were previously allowed, including retaining a 2% claiming threshold. This would require state taxpayers to complete a separate Schedule A to calculate state itemized deductions.

L. Charitable Contributions Deduction

Previous Federal Law:

Taxpayers could deduct any charitable contributions made during the taxable year to charities, federal, state, local, and Indian tribal governments, and certain other organizations, subject to income limitations for certain types of contributions and recipient organizations. Deductions for contributions made in the form of cash and ordinary income property are generally limited to the lesser of 30% of the taxpayer's contribution base or 50% of the taxpayer's adjusted gross income.

Approximately 2.8 million New York taxpayers claimed $19 billion in federal deductions for eligible charitable contributions in 2015.

New Federal Law:

The new federal law raises the income threshold limitation to 60% of adjusted gross income for certain cash contributions to public charities and denies any deduction for payments made in exchange for college athletic event seating rights.

Impact to New York:

Federal deductions for charitable contributions are included in the base amount for the purposes of calculating state itemized deductions. Approximately 2 million state taxpayers claimed $33.5 billion in charitable contribution deductions in tax year 2015.

Absent any legislative changes, this provision would flow through to the calculation of state itemized deductions. However, the provision would not impact the state's existing limitations on itemized deductions for high-income taxpayers. Under current state law, taxpayers with income over $1 million may only deduct 50% of the federal deductions allowed for charitable contributions, and those with income over $10 million may only deduct 25% of those federal deductions.

The state's existing limitations on charitable contributions should mitigate any negative revenue impacts from these provisions.

M. Gambling Losses Deduction

Previous Federal Law:

Losses sustained on wagering transactions could be claimed as an itemized deduction on a federal return to the extent that they exceed any gains during the taxable year from such transactions.

New Federal Law:

The law expands the deduction for gambling losses to include other eligible expenses incurred in carrying on the transaction. Such expenses may include the cost of traveling to or from a casino.

Impact to New York:

Federal deductions allowed for gambling losses are included in the base amount for the purposes of calculating New York itemized deductions. Approximately, 68,000 New York taxpayers deducted a total of $900 million in qualified losses in 2015.

This provision is expected to have a minimal revenue impact at the state level. Nevertheless, the State could consider decoupling from federal law and retain the current definition of eligible gambling losses.

N. 529 Plans

Previous Federal Law:

Federal 529 plans incentivize saving for college and other post-secondary training by allowing investment earnings on contributions to accrue tax-free. New York statutes implementing federal 529 plans allow taxpayers to also deduct up to $5,000 per year (or $10,000 for married couples filing jointly) of contributions to "family tuition accounts," as defined in Article 14-A of the Education Law, allowing for tax-free buildup of both contributions and associated earnings for state income tax purposes. Distributions are tax-free at the federal and New York State level when used to pay qualifying higher education expenses.

New Federal Law:

The new federal law makes several changes to the rules governing education savings, including expanding the use of 529 accounts to include annual distributions of up to $10,000 for K-12 public, private and religious school tuition. In New York, about 195,000 taxpayers claimed about $985 million in qualified contributions on state tax returns in 2015.

Impact to New York:

It appears that distributions for K-12 tuition expenses would not be considered qualified distributions under the New York statutes implementing 529 accounts and would trigger the recapture of any tax benefits that had accrued on contributions. We will continue to review the federal law's provisions on 529 plans on New York residents, and welcome discussion for possible solutions and alternatives.

O. ABLE Accounts

Previous Federal Law:

Achieving a Better Life Experience (ABLE) accounts are designed to encourage and assist individuals and families to save private funds to help individuals with disabilities to maintain health, independence, and quality of life. Accounts are exempt from tax on earnings and distributions, provided the funds are used to pay for qualified disability expenses. Unlike 529 accounts, taxpayers cannot claim an upfront deduction for contributions, but withdrawals for qualified expenses are not taxed.

New Federal Law:

The new federal law allows tax-free rollovers of contributions and earnings from 529 accounts to 529A ABLE accounts.

Impact to New York:

There currently are only several hundred ABLE accounts open in New York State. New York's 529 plan currently allows qualified withdrawals for the death or disability of a beneficiary (without addbacks of contribution deductions). Accordingly, it is possible any such rollovers would not be taxable events. In any event, the change in federal law is expected to have a minimal financial impact to the state.

P. Federal Rehabilitation Tax Credit

Previous Federal Law

The Federal Rehabilitation Tax Credit (RTC) applies to costs incurred for rehabilitation and reconstruction of certain buildings. Generally, taxpayers could claim a credit for 10% of eligible costs for buildings placed in service before 1936 and 20% of eligible costs for certified historic structures.

New Federal Law:

The new federal law maintains the 20% credit for qualified expenses incurred in the rehabilitation of historic structures, with no credit cap, but now requires the credit to be claimed over a period of five years, effectively reducing the present value of the credit for claimants. This program change affects all projects newly owned on or after January 1, 2018. The 10% credit for pre-1936 buildings was repealed.

Impact to New York:

The New York State Historic Tax Credit (HTC) is coupled with the federal credit. Taxpayers are eligible for the state credit provided that: (a) they or their business are eligible for the corresponding federal credit; and (b) their project is located in qualified census tracts. The New York State HTC is a standalone state program that will expire in 2019. As it considers extending this program, New York State could consider decoupling the state credit from the federal in order to avoid any adverse impact on the financing of new projects, particularly for small projects. In addition, the state could consider various proposals to enhance the value of the credit and make technical changes to the program's census track provisions to maintain eligibility for certain communities.

Other Impacts on New York State – Business Tax

The federal tax bill is overwhelmingly a corporate tax restructuring bill. Many components, such as corporate tax rate cut from 35% to 21%, new excise taxes, or changes to federal tax credits, only apply at the federal level. The impact from some federal changes are mitigated by New York's unique corporate tax structure or by prior policy decisions to affirmatively decouple from federal conformity. Nevertheless, New York State faces important policy decisions with respect to corporate taxes.

Because most of the provisions are effective for tax years beginning in 2018, the impacts of the federal corporate tax changes are expected to first occur in the 2018-19 fiscal year because corporations are likely to adjust estimated payments due in 2018 to reflect the changes.

A. Background on New York Corporate Franchise Tax

Most corporations are subject to the corporate franchise tax in Article 9-A of the State Tax Law. The starting point under Article 9-A is federal taxable income (FTI) or effectively connected income (ECI), with the federal deductions for net operating losses and dividends received added back. There are also a number of state-specific modifications that require taxpayers to add back federal deductions or exemptions or allow subtractions for items of income, gain, expense, or New York tax preference. FTI or ECI after these modifications is termed entire net income (ENI).

New York divides ENI into three types: investment income, other exempt income, and business income. Entire net income minus the first two categories results in business income. This amount is subject to an apportionment formula based on New York receipts and the apportioned total is subject to tax. The former two categories are tax exempt, with attributable interest expenses added back to taxable income.

These features – New York's link to federal income as the starting point for computing state tax, state income modifications, and the nature of the three types of income – are the key determinants of the degree of impact from the federal corporate tax changes.

B. International Tax Provisions

The new federal law makes a number of consequential changes to the taxation of multinational businesses. Prior to this law, U.S. corporations were taxed on their worldwide income (FTI), with income earned by a foreign subsidiary generally not being taxable in the US until it was distributed to the U.S. corporation. The law moves from a worldwide basis to a territorial system and creates both one-time and ongoing tax provisions effectuating this transition. Alien corporations were,

and remain, taxable only on income effectively connected with a U.S. trade or business (ECI).

Both before and after the law, certain income earned by a controlled foreign corporation (CFC) of a domestic corporation is deemed to have been paid to the domestic affiliate, even if such income is not actually distributed to the shareholder (Subpart F income, IRC § 951). A CFC is defined as a foreign corporation that is more than 50% owned by one or more U.S. persons, each of which owns at least 10% of the foreign subsidiary.

Subpart F income and dividends paid by foreign affiliates to U.S. corporations are generally not taxed in New York. Subpart F income is statutorily designated as other exempt income by reference to IRC § 951. Dividends from affiliates with no ECI qualify as other exempt income as well.

Article 9-A requires that federal interest deductions attributable to both types of exempt income be added back, thereby increasing taxable business income in New York. Therefore, even if New York will not see a direct revenue gain from income newly taxable at the federal level, it would receive an indirect influx as a result of interest expense addbacks related to this income.

There are three significant provisions impacting corporations with international operations or affiliates. Their impacts are strongly influenced by the federal law's use of Subpart F and by New York's income types.

i. *__Treatment of Deferred Foreign Income Upon Transition to Participation Exemption System of Taxation, i.e. "Deemed Repatriation"__*

The new law requires U.S. shareholders owning at least 10% of a foreign subsidiary to include as Subpart F income the shareholder's pro rata share of accumulated earnings and profits of its foreign subsidiary (IRC § 965[a]). The shareholder is allowed a separate deduction for a portion of the foreign earnings and profits under IRC § 965(c). This income recognition is a one-time event, but taxpayers have the option to pay the net tax liability over eight years.

Including these earnings and profits as Subpart F income means they would be considered other exempt income that is exempt from tax under New York law. Because this income had been retained internationally, this is money New York had not been receiving previously. New York could potentially realize a revenue gain of approximately $60 million resulting from the interest expense attribution related to this exempt income.

However, the new law's companion deduction has caused uncertainty and poses a separate fiscal risk to the state. Generally, New York taxpayers must add back dividends received deductions taken at the federal level. It is unclear whether this new deduction can be characterized as a dividend. If it is not a

dividend, a taxpayer stands to receive a double benefit: the income, reported via Subpart F, would be subtracted from ENI as other exempt income and go untaxed by New York, but the deduction would have already been removed from the starting point at the federal level. Thus, the taxpayer would receive both a deduction and an exemption.

To prevent an inappropriate windfall, the State should enact a new statutory income add-back for the IRC § 965(c) deduction. This would provide the greatest clarity to taxpayers and be the most secure approach to resolving this ambiguity.

If legislation is not enacted and the deduction flows through to New York, a fiscal impact could be felt as soon as the 2017-18 state fiscal year, but more likely in the 18-19SFY. At this time, it is not possible to quantify the potential exposure.

ii. *Current Year Inclusion of Global Intangible Low-Taxed Income (GILTI) by U.S. Shareholders*

U.S. shareholders of CFCs must include their pro rata share of a CFC's global low taxed intangible income (GILTI) in gross income under new IRC § 951A, even if such amount is not actually distributed to the U.S. shareholder. This provision is generally intended to curtail tax avoidance achieved by locating income-producing intangible assets in low-tax havens. The shareholders are allowed a deduction for a portion of the GILTI income (as well as foreign-derived intangible income) under IRC § 250.

Although this new GILTI income is treated similarly to Subpart F income, it is specifically not characterized as Subpart F income under the IRC and therefore would *not* qualify as other exempt income. Thus, the income would flow through to New York, be treated as business income, and be subject to tax.

The deductions provided for under IRC § 250 would also flow through to New York and would not be subject to an add-back because they are not dividends received deductions.

If New York takes no action, the State would tax a portion, but not 100%, of the GILTI income, due to the deduction under § 250. The combined impacts of the income inclusion and flow through deductions are estimated to produce approximately $30 million. New York could also consider measures to capture a greater share of the GILTI income by decoupling from the IRC § 250 deductions or exempting this income from taxation entirely.

iii. ***Dividends Received Deduction for Foreign-Source Portion of Dividends Received by Domestic Corporations from Certain Foreign Corporations***

U.S. corporations will be allowed to deduct 100% of the foreign-source portion of dividends received from certain foreign corporations of which they own at least 10%. Certain dividends are instead treated as Subpart F income and are therefore not subject to the deduction.

This income would flow through to the Article 9-A starting point, but, as discussed above, the dividend and Subpart F income would be other exempt income or investment income and not be taxable in New York. There would be a small increase in taxable income, though, as the pool of interest deductions attributable to this larger pool of exempt income would increase.

The State has not been receiving this income, so there would be no significant revenue loss if no action is taken. In fact, even in the absence of action, the State will realize a small revenue gain from interest expense attribution, estimated at $4 million. Alternatively, the State could generate additional revenue by removing all or a portion of these dividends and Subpart F income from the definition of other exempt income.

C. Other Business Provisions

i. Exclusions and Deductions

The federal bill attempts to offset a portion of the revenue losses by curtailing or eliminating many income exclusions and deductions. The impact on New York is a function of our current conformity status.

- Limiting deductions for business interest expenses has the largest impact for New York State of any provision in the law, estimated to produce approximately $45 million. Business interest expense deductions in excess of 30% of adjusted taxable income would be disallowed. This change would flow through and increase a corporation's New York starting point.

  New York taxpayers must currently add back interest expense deductions related to exempt investment income and other exempt income. The new 30% limit does not apply to investment interest expenses, so that addback will not be effected. The limit could apply to expense attribution for other exempt income. Reducing the pool of attributable expenses would increase the amount of exempt income, but this should be more than offset by the revenue increase from the general business interest expense limitation.

- Limiting the deductions for employee fringe benefits, such as meals, entertainment, transportation, etc. all flow through to New York and increase the New York starting point. Taken together, these limitations produce approximately $15 million.

- Tax-deferred like-kind exchanges would only be allowed for real property used in a trade or business or for investment. Other like-kind exchanges would be required to recognize gain and that gain would flow through to New York. This is estimated to produce approximately $3 million.

- Large financial institutions with assets in excess of $10 billion are subject to a limit on the amount of FDIC premiums they can deduct, determined by formula. This change is estimated to result in approximately $3 million.

- Interest generated by an advance refunding bond (a bond issued to pay for a prior bond issue) will no longer be tax exempt. This change will flow through to New York, but the impact is mitigated by favorable rules determining the share of this type of income apportioned to New York. This is estimated to produce approximately $4 million.

There were two other prominent changes to deductions. The first, repeal of the qualified production activity income (QPAI) deduction, has no impact because New York decoupled from the deduction in 2008.

The second, limitations on net operating loss (NOL) deductions, has a minor and indirect impact on New York taxpayers. Article 9-A is already decoupled from the federal net operating loss, so most corporations are not impacted. However, while New York offers an unlimited, three-year NOL carryback, the law repeals the carryback at the federal level. New York may want to consider conforming to this practice and repeal its existing NOL carryback. Alternatively, the State could take no action.

ii. Federal Provisions Affecting Life Insurance Companies

Insurance companies pay tax under Article 33 of the State Tax Law instead of under Article 9-A. Non-life insurers are subject only to a premiums-based tax, which is essentially an excise tax. Life insurers compute tax on four bases, one of which is income-based, but the tax is capped at 2% of premiums. Article 33 remains conformed to the federal NOL provisions, so life insurers would be impacted by both the elimination of the NOL carryback and the limitation on use to 80% of income. The impacts of these and other minor changes contained in the new law are minimal.

iii. Cost Recovery and Accounting Changes

The law has numerous changes to accounting rules regarding depreciation lives, expensing limits, and income recognition timing. The State tax code is coupled to federal rules on many of these items. Maintaining coupling would be simpler for taxpayers, allowing them to value assets, recognize events, and account for items the same way for federal and state purposes. Nevertheless, there may be provisions for which decoupling is desirable in order, for example, to avoid a significant revenue loss or undesirable state policy change.

One significant provision in the new law enacts 100% temporary expensing for business assets. This would allow taxpayers to immediately deduct the cost of capital investments in lieu of taking smaller annual depreciation deductions. In 2003, New York State decoupled from the section of the IRC creating "bonus depreciation," which offered 30% or 50% expensing. The law amends the same section of the IRC for the 100% expensing provision. Therefore, because New York was already decoupled, this provision will have no impact on New York.

The provision with the greatest potential impact on New York is the change to the treatment of research and experimental expenditures. The law eliminates the option to immediately deduct such expenses and instead requires them to be amortized over a five-year period. Lengthening the term of the deduction will result in increased revenue to New York over time. Alternatively, the State could choose to decouple from these provisions in order to preserve deductibility.

iv. Small Business Changes

The law contains two changes targeted at small businesses, both of which produce a meaningful revenue loss at the state level due to changes that flow through to New York:

- *Immediate expensing*: The law increases the expensing limit from $500,000 to $1 million, increases the income phase-out threshold from $2 million to $2.5 million, and expands the type of property eligible for the benefit. This is estimated to cost New York $17.5 million.

- *Accounting methods reform and simplification*: The federal law raises the eligibility thresholds for using cash v. accrual accounting, valuing inventories, and other accounting methods to $25 million in gross receipts from $5 million or $10 million (depending on the item). This is estimated to cost New York $30 million.

v. Opportunity Zones

The opportunity zone provisions of the new federal law contain several tax incentives for investments in low income areas through "qualified opportunity funds." A qualified opportunity fund is an investment vehicle organized for the purpose of investing in and holding at least 90% of its assets in qualified opportunity zone property. Specifically, a taxpayer can defer inclusion of a capital gain in income if it reinvests the gain in a qualified opportunity fund. Other gains on investments in a fund held for 10 years are eligible for a full income exclusion. The deferral or exclusion of gain will flow through to New York State and is estimated to cost New York approximately $7 million per year. New York could consider decoupling from this provision to avoid these revenue consequences. Alternatively, the State could take no action if it determines that the provision aligns appropriately with state economic development priorities.