



NYS Tax Reform for Fiscal 2019

Let's Take Our Time and Get It Right

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New Tax Environment

Governor Cuomo released his 30-day amendments to the Executive Budget where he outlined his plan for the state's tax system redesign in response to the tax changes at the federal level. The state legislature – both the Assembly and the Senate – reviewed the plan and supplied their respective amendments to the Executive Budget proposal.

The direction taken by the governor is a good one, however, the set of solutions being discussed and the process in which they are discussed could be improved. The challenges New York faces require a comprehensive approach to 1) address the new federal tax environment, 2) improve the structure of the NY state tax system both in response to and regardless of the new federal law, and 3) add appropriate revenue so the state can meet its needs. With a view to achieve that, it is highly advisable to have the proposed tax reform more thoroughly reviewed. It would be advisable to hold multiple hearings in different parts of the state to get valuable insight from experts, public officials, and the general public. There is no reason this needs to be done within the confines of the budget, especially since there are no budget implications.

The federal Tax Cuts and Jobs Act of 2017 (TCJA) has the potential for a multi-stage impact on New York State. First, there are the immediate effects. Some taxpayers will end up paying more in taxes. This may be especially true for some of the state's high-income filers. Second, the deep tax cuts at the federal level are likely to have a negative effect on the federal budget and may, subsequently, force substantial cutbacks to expenditures on various social services and programs. New York relies on the federal funding for such programs, and many may be in jeopardy. Such an outcome would be unfair to New York's taxpayers because New York, a donor state, contributes \$48 billion more to the federal government than it receives back. This should compel the state's leadership to think of a tax reform of their own, one that would hold New York's taxpayers harmless at the minimum or, ideally, even improve the overall state's tax regime.

The federal tax law presents a sweeping reform and the resulting adjustments in taxpayers' behavior are difficult to predict precisely at the time of this writing. For example, the standard deduction has been increased for 2018 to \$12,000 for singles and separate filers, \$18,000 for heads of households, and \$24,000 for joint filers. At the same time, various exemptions and deductions have either been suspended, eliminated or capped. Some taxpayers, may lower their tax liability as a result of their increased standard deduction offsetting or exceeding the lost exemptions. Some taxpayers, especially those with many dependents or those who itemize deductions, may see a higher tax bill as a result of these changes. It will depend, to a large extent, on how much they can benefit, for instance, from enhancements to the child credit.

This means that taxpayers who had itemized their expenses in the past, may find that it makes more financial sense for them to start using the standard deductions going forward. Maybe not. The governor states that the new federal tax regime will cost New Yorkers \$14.3 billion in additional taxes annually unless something is done legislatively at the state level. The current legislative action is pursued to mitigate this negative effect.

This note describes and discusses the amendments to the revenue section of the Executive Fiscal 2019 Budget. These amendments detail the core of the tax policy reform the governor announced earlier this year in response to the new federal tax law. The purpose of the state tax reform is to provide tax relief to the categories of taxpayers who may be negatively impacted by the federal law. One of the main issues is the \$10,000 cap on state and local tax deductibility (SALT). The governor proposes three kinds of measures: a) establishing a new payroll tax based system, b) creating public-purpose charitable organizations, and c) selective decoupling from the federal law. Also, it is worth discussing the unincorporated business income tax (UBT) because it was included in the Summary of Proposed Tax Reforms, although the 30-day amendments omit the proposal.

These proposals are obviously limited in nature and, in their current form, even if taken together, do not go far beyond the attempt to maintain a status quo in some parts of the tax policy universe. The presumed benefit of such an approach lies in the limiting of fiscal change beyond the extensive formal redefinition and rechanneling of the existing funding and revenue streams. Still, the scope of the changes to be introduced, makes it difficult to ignore that the intrusive changes may be costly. The larger picture, which must be addressed, is that the state has a \$4.4 billion structural deficit this year and is likely to face cuts in federal funding next year and beyond. This means the character, viability and success of New York's economic model are threatened at the time when most of the benefits from the federal tax reform accrue to large corporations and the wealthy thereby weakening the effective demand and middle-class income. There's a need for a rational corrective policy that, necessarily, includes new revenue and promotes opportunities for growth.

Payroll tax workaround

The idea of a "payroll tax hack" was proposed by Dean Baker, an economist at the Center for Economic and Policy Research. The premise is simple: if New Yorkers, whose average deduction is over \$22,000, stand to lose the most in the nation as a result of the SALT \$10,000 cap, it may be a good state policy to offer them some federal tax relief by a) lowering the employees' taxable income and b) shifting the deductible tax payments to employers. A well designed combination of the two measures can result in substantial tax savings for New Yorkers. The personal income tax is the main source of revenue for the state. It accounts for about 51 percent of New York's operating budget, while the payroll tax accounts for only 1 percent. Therefore the tax reform that involves the switch of one kind of a tax for another needs to be very well thought through.

The proposed measure establishes a deductible, payroll-side Employer Compensation Expense Tax (ECET). The proposed system design essentially a dual system that combines a progressive PIT and a flat payroll tax on wage expenses of over \$40,000 per worker. Under the proposed Employer Compensation Expense Tax (ECET) employers would be able to opt-in annually by October 1 to provide their employees with federal tax relief. Employees' taxable income will go down, but their disposable income, or take-home pay, should be the same according to the proposed plan. ECET will be phased in 1.5 percent first year, 3 percent second year and 5 percent after that. Filers should get a tax credit that equal to the ECET.

This system provides a partial SALT cap relief, while still taxing the high-income earners at higher tax rates. For example, if a taxpayer paid an 8 percent PIT, after year 3, under the new plan they will get 5 percent paid under ECET and will get the tax credit. The taxpayer will have to pay the remaining 3 percent of tax through the PIT.

The language of the proposal allows both private sector as well as public sector and not-for-profit employers to opt-in. It is not quite clear what incentives not-for-profit and public employers would have for joining such a system aside from employee attraction and retention. Moreover, not all classes of earned income could readily access the benefits this system is proposed to offer. For example, union workers have their earnings stipulated as part of the collective bargaining agreement and, therefore, lowering their stated

earnings by the amount of the payroll tax may be impossible without renegotiation. Also, self-employed, contract, and freelance workers do not have their situations addressed in the proposal. To be successful, the measure must consider the experiences of all types of workers currently active in the state of New York. Otherwise, it only invariably solves the problem for an unacceptably narrow cohort of taxpayers. The scheme needs to be clarified, thought-through, and expanded.

The Assembly, accepted this proposed tax workaround, and it only slightly changed the employer election section in a way that uses clearer language. The payroll tax-based system may be interesting to pursue in its own right, not only as a response to the TCJA. In fact if done correctly, instituting an employer side payroll based system on wage-income may effectively separate the ways in which earned and unearned incomes are taxed. Whether this is useful or desirable needs to be discussed thoroughly.

Charitable organizations scheme

This measure, in the governor's proposal, establishes a mechanism for a system of statewide and local charitable organizations. Similar to the payroll tax workaround this system is called to provide deductibility for contributions to local schools, hospitals and similar entities that were previously levied as taxes but now would be re-classified as charitable donations. Most local taxes normally fund local education and health services. With the new SALT cap at \$10,000, residents in some high-tax counties may face excessive taxation and reclassifying some of their liabilities as charitable donations should save them money and at the very best keep them whole.

Under the federal tax law the limit on charitable deductions was increased from 50 percent to 60 percent of modified Adjusted Gross Income. The governor proposes to set up two new state-operated charitable funds. One, the "health charitable account," will receive donations for healthcare services. The other, the "elementary and secondary education charitable account," will receive contributions for education services. Those of the donors who itemize deductions could claim these charitable contributions as deductions on their federal and state tax returns. Also, they could claim a state tax credit of 85 percent of the donation they made.

Additionally, school districts, villages, towns, cities, and counties can form their own charitable gift funds for education, health care, and other purposes. Taxpayers would get a local credit of 95 percent of the donation against their property taxes.

The language of the governor's proposal is general enough in its definition of the specific purposes of these funds. For example, the proposed education funding scheme does not specify whether charter and parochial schools are included or excluded from it. While the Senate's bill rejects the charitable scheme entirely, the Assembly rejects only the part of the governor's proposal establishing the two state-level charitable funds. Additionally, in its bill, the Assembly, allows for unrestricted donations, gives more flexibility at the local level, and, very appropriately, strengthens the language by making sure that the funds be used for *public* education and *public* purposes, not *general* education or *general* purposes.

While the scheme may potentially save some taxpayers' money, both its viability and usefulness remain to be established. First, the charitable scheme is vulnerable to the legal challenge from the federal level. Second, on the policy level, depending on the final design, the scheme can destabilize funding for essential services around the state.

Decoupling from the federal tax

This measure decouples the State of New York from the federal law in several instances. It includes the following steps proposed by the governor and supported by the state's legislature:

- **Decouple from the SALT cap:** this prevents an automatic tax increase that would result from the way NYS tax deductions are calculated based on the federal deductions. Since they are capped at \$10,000 it would immediately lower the state deductions as well.
- **Decouple from the moving expense deduction elimination:** job-related moving expenses that were traditionally deductible, will no longer be deductible under TCJA on an individual's federal income tax return. This measure preserves some of the moving expenses' deductibility for eligible expenses.
- **Decouple from the repeal and limitation of remaining Federal deductions:** this measure eliminates the requirement that taxpayers may only itemize New York State deductions if they itemize on their federal return.
- **Restore the New York single filer standard deduction:** This measure maintains the standard deduction on taxpayers' state return intact.

Policy recommendations

Governor Cuomo's 30-day amendments sketch a loosely connected complex of measures with an aim of solving the SALT deductibility issue in an array of separate ways. As such, therefore, these solutions are uniquely focused on addressing the needs and concerns of a segment of affected taxpayers. It is important to address the SALT problem. Still, the proposed approach may be insufficient when it comes to solving the problem of the pressure put by the federal government on New York's progressive economic model. Therefore, the proposed state tax reform must be enhanced with a view to address that.

Decoupling

Some decoupling from the federal law may indeed be warranted and should be explored further. It should ideally save money for the state and appropriately provide the benefit to those who need it most by ensuring or enhancing the system's progressivity. In particular, for example, decoupling from the federal child tax credit (CTC) can help the state avoid a \$500 million decrease in annual revenue. Additionally, enhancing the Empire State Child credit to include children under the age of four would be desirable.

Unincorporated business income tax

While the Summary of Proposed Tax Reforms¹ mentions the idea of a state unincorporated business income tax (UBT), the actual 30-day amendments omit the UBT discussion entirely. It may be worth looking into the pass-through entities for possible strategic recapture of windfall benefits as a result of the TCJA. Generally, pass-through business income is set to benefit from a 20-percent deduction. This deduction applies if the taxpayer's total income is below the established threshold amounts. The thresholds are \$157,500 for singles, heads of household, or married couples filing separately and \$315,000 for married couples filing jointly. For taxable incomes above these (and past the phase-out range of \$50,000 for singles, etc. and \$100,000 for married couples) unless the entity is subject to the specified service business phase-out, a wage- or wage-plus-property formula will be applied as follows to determine the deduction for each pass-through entity, which must be limited to the greater of:

- a) 50 percent of the W-2 wage bill
- b) 25 percent of the W-2 wage bill plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.

From the above, it is patently clear that pass-through companies with a substantial quantity of qualified property are set to benefit greatly. As an industry, real estate –where businesses that own and operate properties are routinely set up as LLCs and Partnerships – is poised to gain from the structure of the provision.

¹ <https://www.budget.ny.gov/pubs/archive/fy19/exec/Proposed-Tax-Reforms-Summary.pdf>

New York City has a UBT and its design could be used as a model for the state-wide UBT. NYC applies a 4 percent tax rate on taxable income of unincorporated business entities. The New York City UBT amounts to around \$2 billion in revenues annually. In a similar fashion, the state of New York could apply a tax or surcharge on net pass-through income.

A better way forward

If the state goes forward with an extensive tax reform, of the sort the governor has outlined, it is necessary to consider and implement it carefully and thoughtfully. The proposed tax reform's scope and complexity, which should not be ignored, make it more than a routine budgetary matter. Thus, the resulting design must present a comprehensive economic policy response to the changes in the national fiscal environment. The appropriate way forward is through a deliberative process – perhaps involving a formal commission – that would provide a platform for and invite specific and varied concerns from taxpayers, experts, advocates, and policy-makers.

While some reasonable adjustments in the state tax system may be both necessary and desirable in response to the new federal tax law, they must be done cautiously and strategically with a long-term economic view in mind. New York's economy and average taxpayers must end up better off as a result of the changes made for the changes to be worth doing as a fiscal policy matter. Additionally, if the state's fiscal environment could benefit from some recalibration, then it ought to be pursued in its own right for the benefit of New Yorkers. It is a much larger discussion than the budgetary process could – or should – accommodate. Therefore, this reform requires its own forum and process; and there is ample time to organize it and run it well. It is clear that the views on the proposed tax reform are different between the governor who came up with the reform, the Assembly that modified the proposal and the Senate that rejected it. In the professional and expert communities opinions on the matter vary as well. These different views and valid concerns are a good reason to form a tax reform commission tasked with a comprehensive examination of the plan of the reform. It needs to run a formal process: hold hearings, take input and do the research as necessary.

Improving New York's tax system is a considerable policy undertaking. It requires bold vision, great leadership, and appropriate process. Without all three components in place we may only expect to achieve haphazardly partial solutions or – what is more likely – nothing at all.