



## *New York State's Continuing Tax Reform: governor's unincorporated business income tax proposal*

Comments submitted to NYS DOTF in response to the discussion draft of an unincorporated business tax (UBT)

Ron Deutsch and Jonas Shaende

*July 16, 2018*

The State of New York continues to evaluate possible adjustments to its tax system in response to the federal Tax Cuts and Jobs Act of 2017 (TCJA). Governor Cuomo proposed the idea of a statewide unincorporated business income tax (UBT) in early 2018. Perhaps due to the complexity involved, the UBT did not make it into the state budget package along with the other response measures: a payroll tax workaround, decoupling of rules for itemized deductions and other state tax rules from the federal tax code, and a mechanism to allow charitable contributions to substitute for taxes.

Similar to the measures passed, the main point of the proposed unincorporated business tax is to maintain federal tax deductibility for some New York taxpayers. The taxpayers in question are mainly those who may be negatively affected by the new \$10,000 cap on state and local tax deductions (SALT) brought about by the new federal tax law. The UBT in the governor's proposal is intended to provide relief to the earners of nonwage income who receive income via pass-through unincorporated entities such as LLCs and partnerships. The Fiscal Policy Institute is pleased to have a formal opportunity to offer some comments on the matter as we view a meaningful state tax reform as a both necessary and desirable response to the TCJA.

### **FPI's suggestions**

- Improve public input process: form a tax reform commission and hold hearings;
- The state tax reform must take into account the composition of new winners and losers due to the TCJA and resulting changes in the economy and taxpayer behavior;
- UBT scheme should start as an optional system until there is clarity about its effect;
- UBT should be above 5 percent to be attractive to taxpayers with lower incomes;
- PIT credit should be set below the usual 93 percent at higher incomes; The Fiscal Policy Institute suggests setting the PIT credit at a lower percentage would contribute to increasing progressiveness of the state's income tax structure and would generate additional revenue.
- S corporations should be included;
- Real estate firms are expected to benefit greatly as a result of TCJA and should be subject to the new UBT, but their owners should only be allowed to claim a UBT-based PIT credit below 93 percent. The FPI suggests setting the credit at a level where a considerable recapture of the windfall gains due to TCJA can be secured.

### **Deliberative process**

The FPI had the honor of being involved in the early tax reform design deliberations as a member of the state's leading experts roundtable hosted by Governor Cuomo's office. It would be better if there were more such forums to guide the tax reform with a process that would involve input from

the public, professionals, and elected officials. This is why soliciting comments for the UBT proposal is a definite improvement. However, the FPI maintains its position that the process does not go far enough to seek and absorb the public input and facilitate public debate on the very important and complex tax policy issue. The FPI suggests forming a New York tax reform commission and hold extensive hearings on the matter of the UBT proposal and other state tax policy issues appropriately linked to the TCJA response. This would ensure that the tax structure modifications are done properly.

### **UBT's purpose**

The proposed UBT scheme's purpose is to create additional federal tax deductibility for New York tax payers by taxing pass-through incomes at the entity level and then offering a partial personal income tax (PIT) credit. While the proposal aims to hit some pass-through income deductibility targets, it, in our view, regrettably misses the mark of situational and economic awareness about the dynamic balance of wins and losses due to the TCJA. That is, taxpayers who are hurt by one aspect of the federal tax change are often helped by others. We do not need to pursue restoring everything to the way it was before, the state should focus on New Yorkers who may be genuinely hurt by the new economic and fiscal reality. Addressing these problems may require capturing additional revenue from those who are set to receive windfall benefits as a result of the new tax law. If such assessment are not done, there will be a significant risk that the losers may be ignored while the winners get awarded additional benefits.

### **Design and implementation**

Similar to the payroll tax workaround, any new state UBT should—at least during its initial implementation—be optional; taxpayers should be allowed to opt-in if they estimate doing so would benefit them. Additionally, a UBT rate of 5 percent may be too low to sufficiently benefit taxpayers whose net incomes are modest. It would make sense to set UBT at a higher level than 5 percent.

In order to restore and maintain New York's tax system progressivity, the PIT tax credit due to UBT should be set below the proposed usual 93 percent for pass-through incomes in the high-income category. Moreover, this will recapture some of the windfall gains top earners are set to enjoy under the new tax law.

Many businesses in the state choose to operate as S corporations to secure the benefit of being a pass-through entity. Since LLC registration in New York is slightly more cumbersome than an S corporation, a substantial number of small businesses operate as S corporations. For this reason it would be a good business-friendly and opportunity sharing policy to extend the UBT mechanism under this proposal to include S corporations as well.

### **Unincorporated real estate sector entities**

In its March-2018 position paper, the Fiscal Policy Institute notes:

“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.”<sup>1</sup>

This means that the real estate sector will benefit even more from the state UBT, if it is adopted as proposed without changes. Even if the objective of the UBT proposal is solely to restore taxpayers’ tax-related financial position to its original pre-TCJA level—which it should not be—then all UBT-paying taxpayers in the real estate sector should only be allowed to claim a UBT-based PIT credit far below the proposed usual 93 percent. The UBT mechanism should serve to restore economic fairness in New York’s tax system, and the FPI suggests setting the PIT credit at a percentage level that would be sufficient for recapture of some or all of the windfall gains due to TCJA.

*Ron Deutsch is Executive Director and Jonas Shaende is Chief Economist of the Fiscal Policy Institute.*

*The Fiscal Policy Institute ([www.fiscalpolicy.org](http://www.fiscalpolicy.org)) is an independent, nonpartisan, nonprofit research and education organization committed to improving public policies and private practices to better the economic and social conditions of all New Yorkers.*

---

<sup>1</sup> Fiscal Policy Institute. “NYS Tax Reform for Fiscal 2019 – Let’s Take Our Time and Get It Right”. March, 2018.