Blanche Lark Christerson
Managing Director,
Senior Wealth Strategist

Tax Topics

2018-04

04/30/18

New York responds to the "SALT" limitation

The Tax Cuts and Jobs Act (TCJA) is the informal name for the major tax legislation enacted on December 22, 2017 (P.L. 115-97). Among its many changes are reduced individual income tax rates, from 2018 through 2025 – largely paid for by reducing or eliminating various tax benefits for individuals. Perhaps the most significant reduction is the effective elimination (from 2018 through 2025) of what's known as the "SALT" deduction for state and local taxes, which is now capped at $10,000 (single taxpayers and married filing jointly) or $5,000 (married filing separately).

The SALT limitation is likely to especially hurt high-tax states such as New York, New Jersey and California, where taxpayers will no longer be able to take significant deductions for state and local income taxes, real property taxes, etc., and thereby save themselves substantial federal income tax dollars. Governors of these high-tax states have vowed to implement "work-arounds" to help mitigate anticipated fallout from the cap, such as a possible exodus of wealthy taxpayers and declining property values.

New York is leading the charge with its Fiscal Year 2019 Budget (S. 7509-C/A. 9509-C), which Gov. Andrew Cuomo signed into law on April 12, 2018. The legislation's two key SALT work-arounds are designed to reduce taxpayers' taxable income, and involve contributions to specified New York State charitable funds and a voluntary payroll tax that employers would pay. Contributions to the charitable funds aim to generate both federal and state charitable income tax deductions *and* state income tax credits; the payroll tax will also generate state income tax credits. Whether taxpayers (and the IRS) will embrace these measures remains to be seen, but in the meantime, here are some details:

Charitable contributions. Part LL of the New York legislation "hereby" establishes a special "charitable gifts trust fund" in the joint custody of the Commissioner of Taxation and Finance and the State Comptroller. The fund will be split into a separate "health charitable account" and an "elementary and secondary education charitable account" to which taxpayers can contribute what appear to be unlimited amounts; beginning in 2019, taxpayers will be entitled to an *income tax credit* equal to 85% of the contribution they made in the *immediately preceding* year. (In other words, apparently, the accounts will be able to accept contributions in 2018 so that taxpayers can use the credit in 2019.)

The legislation also permits "qualified contributions" to existing state-sponsored funds: Health Research, Inc., the State University of New York Impact Foundation and the Research Foundation of the City University of New York. Qualified contributions to each of these existing funds are capped at $10 million annually; contributors won't know until after October 1st of the year they contribute whether all, or only a portion, of their contribution is qualified (this is the earliest date the funds will send a "contribution authorization certificate" to contributors, who must apply for the certificate). Qualified contributions are also entitled to the same 85% tax credit in the subsequent year.

Finally, the legislation permits local municipalities and school districts to establish similar charitable funds; contributions to such funds would generate up to a 95% *real property tax credit*, depending how the municipality structured the credit, which could be lowered or capped.

Comments. Although SALT is an "add-back" in the computation for the alternative minimum tax (AMT), taxpayers who paid "enough" regular income tax to be outside the scope of the AMT could take the deduction, which could be significant and save them thousands of federal income tax dollars. (The AMT is a parallel tax system that requires taxpayers to figure their taxes twice – the "regular" way and the AMT way; they pay whichever amount is higher.) With the SALT deduction capped at $10,000, wealthy taxpayers could now owe much more federal income tax. Thus, the desire for state work-arounds.

Yet here's the issue with SALT work-arounds: the SALT cap, along with other limitations on itemized deductions, is projected to bring in some $670 billion in additional tax revenue over ten years, thereby helping to fund TCJA. The federal government is therefore counting on these dollars, and is unlikely to look favorably upon state-law changes designed to stymie the SALT cap. What does this mean for New York's provisions? The answer is unknown.

Republican Congressman John Faso, who represents the 19th District of New York (covering the Catskills and the Hudson Valley), has been seeking clarification on the issue, and has twice written to Assistant Secretary for Tax Policy and acting IRS Commissioner, David Kautter. Rep. Faso urges that "Treasury quickly review the state law changes to determine if these amendments are consistent with federal law." His specific concern is whether the "contributions" mentioned above would meet the test for a charitable deduction since "presumably" the taxpayer is receiving governmental benefits by way of the tax credits. We are unaware if he received a response.

New York's recently released three-page "Summary of Tax Reforms FY 2019 Enacted Budget" states that taxpayers who itemize their deductions (instead of taking the standard deduction) will be able to take both a federal and state income tax deduction for their contributions to these charitable accounts, and notes that taxpayers can also claim the 85% state income tax credit in the year following their contribution.

But is that really so? Although New York can decide what is deductible for state purposes, it does not control federal deductibility; thus, whether the IRS will agree with the Summary's conclusion that donations are eligible for a federal income tax deduction is an open question. (It is also surprising that New York would offer *both* a deduction and a credit, even though it limits charitable deductions for high-income taxpayers.)

There are arguments for and against allowing a federal income tax deduction for the donation, which generates an 85% state income tax credit in the following year. *For:* the donation does not necessarily generate a "quid pro quo" (this for that) since the taxpayer might not claim the tax credit; this could happen, for example, if the taxpayer moves out of New York in the year of the donation, or dies on January 1st of the year following the donation; plus, the credit relates to a different tax year. *Against:* donations don't stem from disinterested generosity, and taxpayers are clearly getting something more than just a deduction for their contribution – they are also getting a state income tax credit, albeit in a different tax year. This is, in fact, a classic quid pro quo.

Putting the deductibility debate to one side, another question arises: could these contributions backfire on New York? That is, suppose that the new health and education charitable accounts are wildly successful: taxpayers flood them with millions of dollars, and reduce their current year federal (and state) income tax liability thanks to the charitable deduction for their contribution; they further reduce their New York State income tax liability the following year because of the 85% credit. Although the new accounts are handsomely funded, New York now has fewer "general" tax dollars to fund other important services, such as police, fire fighters, road repairs, etc. What then?

The bottom line is that until there is clarity regarding the validity of the federal deduction for charitable contributions to these state funds, caution seems advisable: if taxpayers take the deduction and it is later disallowed, their underpaid taxes will trigger interest and penalties.

Voluntary payroll tax. Part MM of the New York legislation adds new Article 24 to the tax law, entitled the "Employer Compensation Expense Program." This measure allows an employer to make an annual election by December 1st of a given year to have this new state payroll tax apply in the following year. The tax applies to employee compensation in excess of $40,000 annually, at a rate of 1.5% in 2019, 3% in 2020, and 5% thereafter; employers cannot deduct the tax from the employee's wages (it is presumably a deductible business expense). Because employees would receive a New York State income tax credit for the tax, based on a formula, they would pay less New York state income tax.

Comments. It is difficult to imagine employers willingly subjecting themselves to this additional payroll tax: it may be cumbersome to implement and entails upfront costs they cannot recoup from their employees. Also, if an employer opts in to the payroll tax, the employee's resulting tax credit is presumably a taxable benefit…which seems to further complicate matters.

Additional New York measures. Part JJ of the new legislation "decouples" New York from some of the other TCJA changes that adversely affect individuals. Because these new provisions reduce a New York taxpayer's taxable income, they serve as additional SALT work-arounds, minus the controversy. Here are some details:

— **Alimony.** New York will still permit the payor spouse to deduct alimony or separate maintenance payments, which will still be taxable to the payee spouse. (Under TCJA, for divorce or separation agreements entered into after December 31, 2018, the payor spouse can no longer deduct those

payments, and the payee spouse will no longer be taxable on them – a permanent, rather than temporary, change.)

— **Moving expenses.** Moving expenses will continue to be deductible, and employer-reimbursed moving expenses will not be taxable for New York purposes. (TCJA eliminated these provisions from 2018 through 2025, except for those in the Armed Forces.)

— **Itemized deductions.** Formerly, New York only allowed taxpayers to itemize their New York deductions IF they itemized their federal deductions, something that seems less likely, given the virtual elimination of SALT and the near doubling of the standard deduction (for 2018, it is $12,000 for single taxpayers and $24,000 for married filing jointly). New York will now permit taxpayers to itemize their New York deductions regardless of whether they itemize federal deductions or take the standard deduction. New York also now defines itemized deductions as federal deductions from gross income (other than personal exemptions) as they would have been prior to TCJA (subject to New York's usual modifications (plus or minus) to these deductions).

Comments. New York already disallows certain deductions that existed prior to TCJA (such as state and local income and sales taxes), and limits charitable deductions for high-income taxpayers. Thus, the deductions likely to return include: 1) interest on mortgage indebtedness up to $1 million and interest on up to $100,000 of home equity indebtedness (from 2018 through 2025, TCJA reduced mortgage indebtedness from $1 million to $750,000 and eliminated the deduction for home equity interest); and 2) miscellaneous itemized deductions, such as tax preparer fees.

To sum up. Other states affected by the SALT cap are closely watching New York's work-arounds. It will be interesting to see how Treasury and the IRS respond to them.

May 7520 rate

The May 2018 7520 rate remains at 3.2%, where it was in April. The May mid-term AFRs are: 2.69% (annual), 2.67% (semiannual), and 2.66% (quarterly and monthly). The April mid-term applicable federal rates (AFRs) were: 2.72% (annual), 2.70% (semiannual), 2.69% (quarterly) and 2.68% (monthly).

Blanche Lark Christerson is a managing director at Deutsche Bank Wealth Management in New York City, and can be reached at blanche.christerson@db.com.

The opinions and analyses expressed herein are those of the author and do not necessarily reflect those of Deutsche Bank AG or any affiliate thereof (collectively, the "Bank"). Any suggestions contained herein are general, and do not take into account an individual's specific circumstances or applicable governing law, which may vary from jurisdiction to jurisdiction and be subject to change. No warranty or representation, express or implied, is made by the Bank, nor does the Bank accept any liability with respect to the information and data set forth herein. The information contained herein is not intended to be, and does not constitute, legal, tax, accounting or other professional advice; it is also not intended to offer penalty protection or to promote, market or recommend any transaction or matter addressed herein. Recipients should consult their applicable professional advisors prior to acting on the information set forth herein. This material may not be reproduced without the express permission of the author. "Deutsche Bank" means Deutsche Bank AG and its affiliated companies. Deutsche Bank Wealth Management represents the wealth management activities conducted by Deutsche Bank AG or its subsidiaries. Trust and estate and wealth planning services are provided through Deutsche Bank Trust Company, N.A., Deutsche Bank Trust Company Delaware and Deutsche Bank National Trust Company.
© 2018 Deutsche Bank AG. All rights reserved. 026865 043018