State Tax Issues after the TCJA: NY, CT and NJ

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Agenda

- Understanding the State and Local Impact of the Tax Cuts and Jobs Act ("TJCA")

- Specific State Responses

- The Loss of the SALT Deduction and Residency

Part 1

Understanding the State and Local Impact of the Tax Cuts and Jobs Act (“TJCA”)

Understanding the Tax Cuts and Jobs Act: State and Local Tax Issues

- **The Tax Cuts and Jobs Act of 2017** (P.L. 115-97) was signed into law on Dec. 22, 2017

- Enacts the most significant federal tax law changes in decades
  - Broadens the tax base for federal individual income tax, while reducing the rates
  - Overall reduction in federal corporate income tax

- But how does all of this impact state and local income taxes?

State Approaches to Federal Conformity

States generally use one of three approaches:

1. **Rolling Conformity** – State automatically implementing federal tax changes as they are enacted, unless the state specifically decouples from a particular provision
2. **Static (or "Fixed Date") Conformity –** State incorporates IRC updates at a specific point in time, rather than adopting all changes on a rolling basis
3. **Selective Conformity** – State only incorporates certain IRC provisions or definitions by reference, but omits large swaths of the IRC and foregoes use of federal definitions of "income" as their own starting points for calculation

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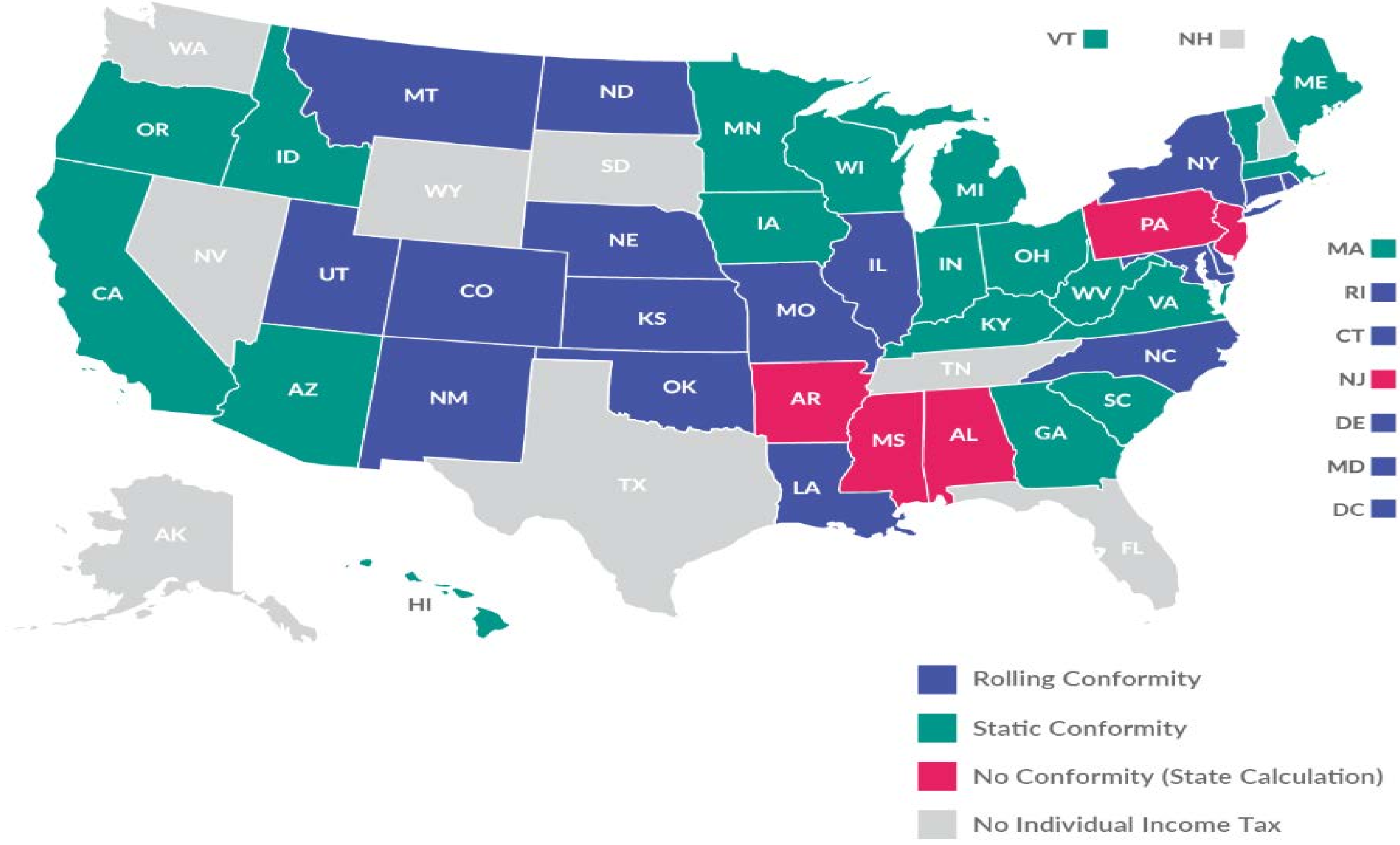
Federal Tax Changes with State-Tax Consequences

- **SALT Deduction** Limited to $10,000
- Increased **Standard Deduction**
- Repeal of the **Personal Exemption**
- Increased **Child Tax Credits**
- Lower cap on the **mortgage interest deduction**
- Temporarily-Lower Threshold for Claiming the **Medical Expense Deduction**
- Repeal of the **Moving Expense** and **Alimony Deductions**
- New **20% Pass-Through Deduction**
- Changes to **Interest Deductibility**
- Changes to **Section 179 Pass-Through Expensing** and **Bonus Depreciation**
- Adjustments to **Net Operating Loss Provisions**
- Repeal of **Section 199 and Modification of other business tax credits**
- Modifications to **Subpart F Income**
- Reduced **Dividends Received Deduction**
- **Deemed Repatriation** (one-time windfall)
- Higher **Estate Tax Exemption**

Individual Income Tax Conformity



"Income" Starting Point on Federal Individual Income Tax Return

Federal AGI (29 states): Before standard deduction, personal exemption (repealed), or pass-through deduction (new)

Adjusted Gross Income

23	Educator expenses	23
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24
25	Health savings account deduction. Attach Form 8889	25
26	Moving expenses. Attach Form 3903	26
27	Deductible part of self-employment tax. Attach Schedule SE	27
28	Self-employed SEP, SIMPLE, and qualified plans	28
29	Self-employed health insurance deduction	29
30	Penalty on early withdrawal of savings	30
31a	Alimony paid b Recipient's SSN	31a
32	IRA deduction	32
33	Student loan interest deduction	33
34	Reserved for future use	34
35	Domestic production activities deduction. Attach Form 8903	35
36	Add lines 23 through 35	36
37	Subtract line 36 from line 22. This is your **adjusted gross income**	37

Federal Taxable Income (6 states): Includes standard deduction, personal exemption (repealed), and pass-through deduction (new)

Form 1040 (2017) Page 2

Tax and Credits

Standard Deduction for— • People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions. • All others: Single or Married filing separately, $6,350 Married filing jointly or Qualifying widow(er), $12,700 Head of household, $9,350

38	Amount from line 37 (adjusted gross income)	38
39a	Check if: { You were born before January 2, 1953, Blind. / Spouse was born before January 2, 1953, Blind. } Total boxes checked 39a	
b	If your spouse itemizes on a separate return or you were a dual-status alien, check here 39b	
40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)	40
41	Subtract line 40 from line 38	41
42	**Exemptions.** If line 38 is $156,900 or less, multiply $4,050 by the number on line 6d. Otherwise, see instructions	42
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43
44	**Tax** (see instructions). Check if any from: a Form(s) 8814 b Form 4972 c	44
45	**Alternative minimum tax** (see instructions). Attach Form 6251	45
46	Excess advance premium tax credit repayment. Attach Form 8962	46
47	Add lines 44, 45, and 46	47
48	Foreign tax credit. Attach Form 1116 if required	48
49	Credit for child and dependent care expenses. Attach Form 2441	49
50	Education credits from Form 8863, line 19	50
51	Retirement savings contributions credit. Attach Form 8880	51
52	Child tax credit. Attach Schedule 8812, if required	52
53	Residential energy credit. Attach Form 5695	53
54	Other credits from Form: a 3800 b 8801 c	54
55	Add lines 48 through 54. These are your **total credits**	55
56	Subtract line 55 from line 47. If line 55 is more than line 47, enter -0-	56

Source: Tax Foundation

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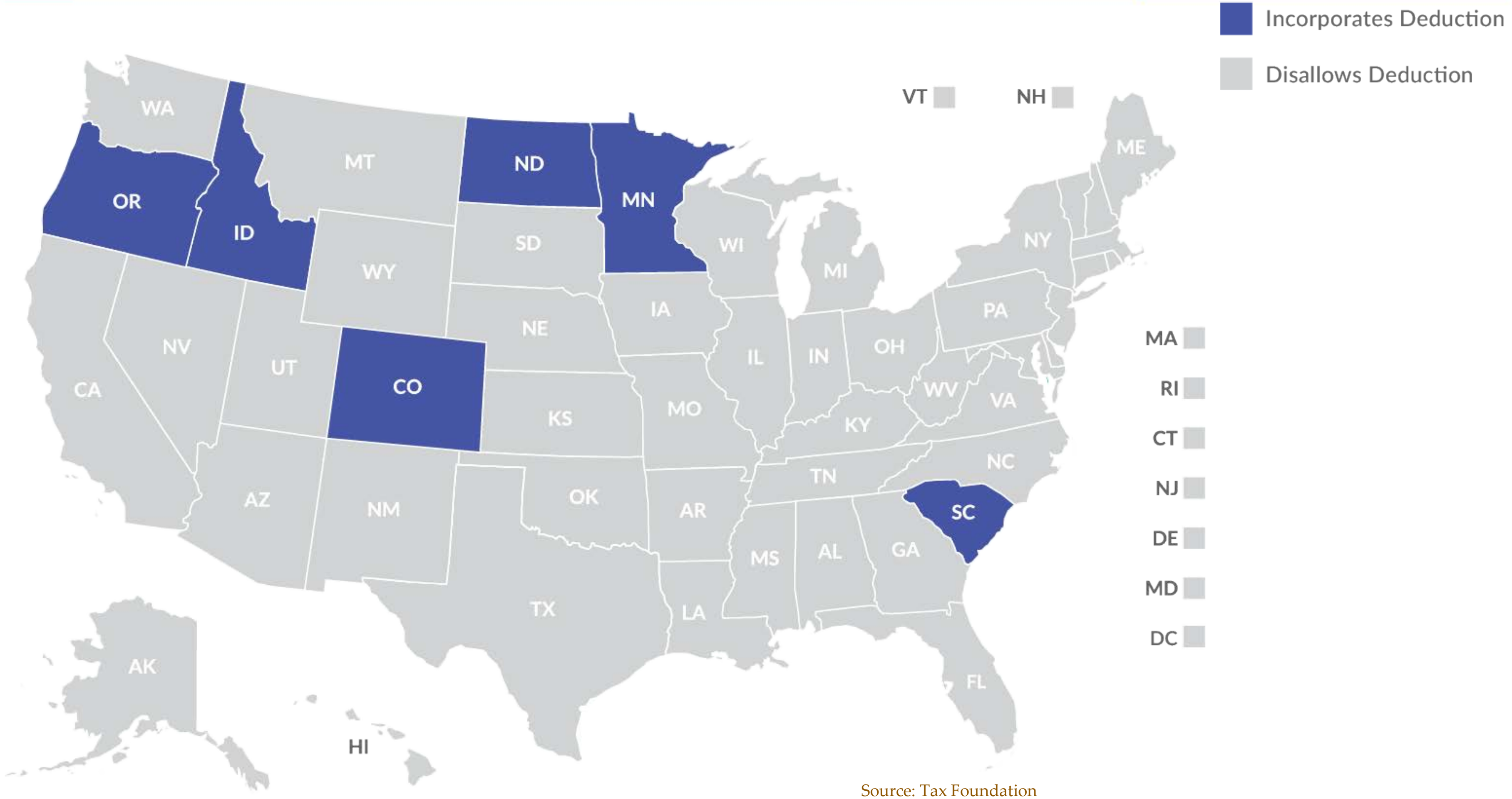
Ex: States that Incorporate the Pass-Through Deduction



Source: Tax Foundation

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Part 2

State Responses: NY, CT and NJ

New York State’s Response to the TCJA

- NY still looking at a $4.4 billion budget deficit
- NY contributes $48 billion per year more to the federal government than it gets back
- SALT deduction denial will cost New Yorkers an additional $14 billion
    - “*An attack on New York’s economic future*.” – Governor Cuomo (1/4/2018)
  - What did New York do?
    - **Part One:** Enacted the Employer Compensation Expense Tax
    - **Part Two:** Established a state-administered charitable trust fund and authorize local governments to create charitable gift reserve funds to support education, health care, and other charitable purposes
    - **Part Three:** Proposed a New Unincorporated Business Tax
    - **Part Four**: Lawsuit against the feds!

New York State Response
Part One: The ECET

For "Electing Employers"

- **Annual Election** – Must be made by employer to opt-in to the ECET system
  - Election to participate must be made by December 1st of the preceding calendar year
- **Annual Tax** – Employers that opt-in are subject to a 5% tax on all annual payroll expenses in excess of $40k per employee, which is phased in over 3 years (beginning on 1/1/2019) → the tax is deductible for employer
- **Rate phase-in:**

Year(s)	ECET Rate
2019	1.5%
2020	3%
2021 & beyond	5%

New York State Response
Part One: The ECET

Potential Pitfalls:

- **Reducing employee compensation** – Not likely to be understood by all employees
- **Company-wide implementation** could be tricky, since many employees may not have benefitted from a SALT deduction in the first place (because they don't itemize or are in AMT)
- **Other Issues** – Calculation of 401k limits/matches, pension, FICA, etc.
- **Nonresidents** – Not advantageous for nonresidents who live in other states with an income tax, since lower NY tax would simply decrease resident credit in home state

New York State Response
Part Two: Options for Charitable Deductions

- For tax years beginning on or after January 1, 2019, individual taxpayers are allowed an income tax credit equal to 85% of any donation made to certain state-operated charitable funds for the tax year following the year in which the donation is made
- The charitable funds include:
  - The State University of New York Impact Foundation
  - The Research Foundation of the City University of New York
  - Health Research, Inc.
  - The Charitable Gifts Trust Fund

New York State Response
Part Two: Options for Charitable Deductions

- Political subdivisions—such as school districts, counties, towns, cities, and villages—are now authorized to create similar funds for education, health care, and other charitable purposes
- Donations to these local charitable funds would result in a local credit, reducing local property taxes equal to 95% of the donation, or a lower percentage as established by the political subdivision

IRS Response
Part Two: Options for Charitable Deductions

- **IRS Notice 2018-54 (5/23/18):**

  "In response to th[e] new limitation, some state legislatures are considering or have adopted legislative proposals that would allow taxpayers to make transfers to funds controlled by state or local governments, or other transferees specified by the state, in exchange for credits against the state or local taxes that the taxpayer is required to pay. The aim of these proposals is to allow taxpayers to characterize such transfers as fully deductible charitable contributions for federal income tax purposes, while using the same transfers to satisfy state or local tax liabilities. Despite these state efforts to circumvent the new statutory limitation on state and local tax deductions, <u>taxpayers should be mindful that federal law controls the proper characterization of payments for federal income tax purposes</u>."

- Proposed Regs Issued on Aug 23, 2018
  - No deduction if taxpayer obtains offsetting state tax credit
  - Ex: $100K donation yield $85K NY tax credit = only $15K can be claimed on Schedule A

- Donations before August 27?

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New York State Response
Part Three: Proposed UBT

- To address the limitation of the federal tax deduction for state tax paid on flow-through income, the state has floated a draft of a new Unincorporated Business Tax which would be calculated at 5% of Line 1 Ordinary Income (plus, among other items, guaranteed payments to partners) apportioned to the state.
- Three credits are proposed:

1. A UBT credit for upper-tier partnerships for their share(s) of the UBT tax paid at lower tiers
2. A PIT credit to individual partners for 93% of their share of the UBT tax paid by the partnership
3. An Art. 9-A credit to corporate partners for 93% of their share of the UBT tax paid by the partnership

New York State Response
Part Three: Proposed UBT

Will it work?

- Maybe, but the credit's benefit to resident PIT taxpayers will be limited by apportionment at the partnership level
- And for nonresidents who would otherwise get a credit in their resident state for taxes paid in New York, will that credit evaporate?
- Corporate partners will get a double limitation based on apportionment at the partnership level and the partner level

New York State Response
Part Four: Lawsuit!!

- July 2018 lawsuit: NY, CT, NJ and MD sue the feds!
- Position: The SALT deduction cap is unconstitutional and should be blocked from enforcement
- Arguments:
  - the SALT cap was enacted to target New York and similarly-situated states;
  - It interferes with states' rights to make their own fiscal decisions;
  - that it disproportionately harms taxpayers in those states
- Chance of success: about equal to chance that Tim will be able to retire early

New Jersey's Response to the TCJA
Property Taxes as "Charitable Donations"

- New Jersey enacted a law that will allow state residents to declare property taxes as charitable donations

- The law will allow property owners to donate up to 90% of their tax bill to charitable funds set up by municipalities in exchange for tax credits

- Many legal and tax analysts believe New Jersey will have to fight the IRS in court after taking this step
    - Acting IRS Commissioner David Kautter told a congressional committee in February that charitable contributions can only be deducted if "the primary purpose of the contribution is donative, which is a disinterested and detached interest of generosity"

CT Response to TCJA

- New Pass-Through Entity Tax!
  - Effective 2018, PTEs doing business in CT subject to entity level-income tax of 6.99%
  - Partners/members/S corp shareholders in turn entitled to CT tax credit equal to 93.01% of their direct or indirect share of the PTE's PE Tax liability
  - PTE must have paid the PE Tax prior to owner claiming the credit.
  - Will NY give its residents a credit?
- Similar charitable deduction scheme for property taxes
- Other business tax changes in response to the TCJA
  - Decouple from bonus depreciation
  - Decouple from limitation on interest expenses
  - DRD and GILTI
- Other interesting development: an end to the "convenience rule" problem!

Part 3

The SALT Deduction and State Tax Residency

MORE ON THE LOST SALT DEDUCTION

- Top Federal Tax Rate decreased to 37%
- BUT…
  - SALT deduction limited to $10,000
  - Other limitations on mortgage interest deduction, alimony, personal exemptions and most itemized deductions
- Result – <u>BAD</u> for (some) NY, NJ and CT taxpayers

ILLUSTRATION: OLD LAW

- Assumptions
  - Single taxpayer, $1 million of income, NYC resident
  - $120,000 of NYS/C Tax
  - $20,000 property tax
  - $40,000 mortgage interest on $1 million apartment
- Taxable income: $820,000
- Federal tax: $324,000
- Total state/federal tax: **$444,000**

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ILLUSTRATION: NEW LAW

- Assumptions
  - Single taxpayer, $1 million of income, NYC resident
  - $120,000 of NYS/C Tax: NOT DEDUCTIBLE
  - $20,000 property tax: ONLY $10K DEDUCTIBLE
  - $40,000 mortgage interest on $1 million apartment (purchased in 2018): ONLY $30K is deductible because of new limitations
- Taxable income: $960,000
- Federal tax: $355,000
- Total state/federal tax: **$475,000**
- INCREASE: **$31K** – more than a 3% increase in effective tax rate

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The Best Response to the TCJA?

- Florida here we come!!!!
  - See Noonan's Notes and Bloomberg articles

- Noticeable uptick in residency changes?
  - Increased importance of residency knoweldge
  - It's not just 6 months and a day outside the state!

- Expect a corresponding uptick in residency audits in NY
  - What about CT and NJ?

Significant Taxes Are At Risk for States…

The top 1 percent pay an estimated third or more of total state income taxes in NY, NJ, and CT.

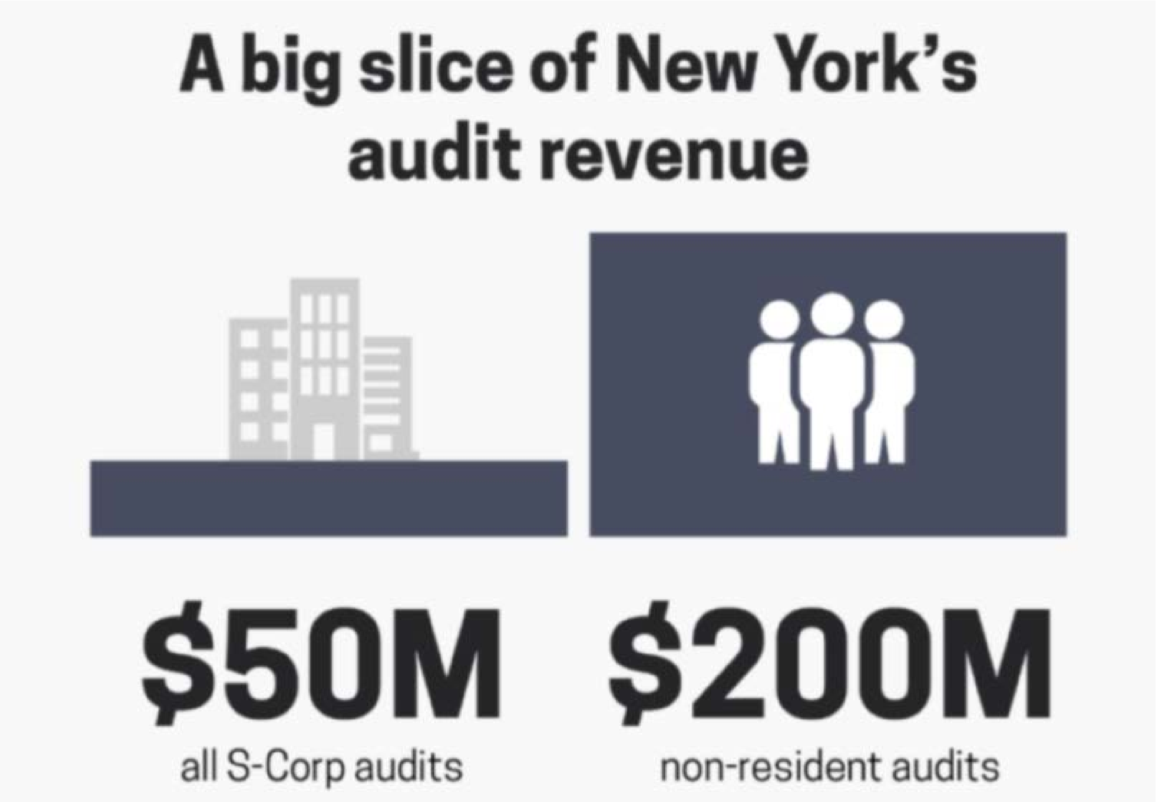
- CT: "It is a growing problem. If one of the very top should go . . . that's a noticeable blip on the radar. In December of 2016 we woke up to a $450 million revenue shortfall because of (HNIs) making certain decisions." *-- Kevin Sullivan, former Connecticut Commissioner of Revenue Services*

- NJ: New Jersey found itself millions of dollars short when one of its wealthiest residents worth $11B changed residency in 2016 and no longer owed the state income taxes.

For New York, its HUGE Tax Dollars…

Source: Secured by Monaeo, Inc. via a FOIA request from the NYS Department of Taxation and Finance

…Dollars They Don't Let Go Without a 'Fight'



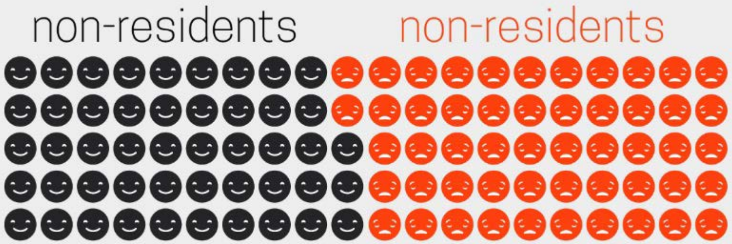
Source: Secured by Monaeo, Inc. via a FOIA request from the NYS Department of Taxation and Finance

1-in-2 Taxpayers Audited, Loses

15,122

New York non-residency audits in the last five years

Most non-New Yorkers can't prove they're non-residents of New York



52%

lose their non-residency audit to New York state

Source: Secured by Monaeo, Inc. via a FOIA request from the NYS Department of Taxation and Finance

And it is Well Worth It for the State

Non-resident audits are a big pain for the taxpayer

$67,000

on average collected by New York in non-resident audits

that's equivalent to the cost of a Tesla Model S

Source: Secured by Monaeo, Inc. via a FOIA request from the NYS Department of Taxation and Finance

Data is Key: CLASSIC approach

- Calendar, Personal diary
- Credit card, EZPass statements
- Travel itineraries, Flight records, Limo logs
- Landline call logs
- **Cellphone – call logs** (AT&T, Verizon, T-Mobile, others)

INCOMPLETE

UNRELIABLE

RETROSPECTIVE

UNSTRUCTURED

Data is Key: MODERN approach

Automated Mobile Residency Tracking

- **Reliable** ➲ audit-ready, audit-tested
- **Contemporaneous** ➲ advance planning, accurate compliance, and audit-defense
- **Easy to use** ➲ set it and forget it
- **Minimal** battery drain
- **Collaborative** ➲ accountant, assistant access
- **Private** and **secure**

Monaeo update: **Taxpayers Served at Scale for 6+ years**

25m+
trips

’000s
HNI users

180+
countries

50+
U.S. regions

* Based on self-reporting by clients who have been audited. Past performance does not guarantee future results.

THANK YOU