Long Island Business News

Empire State strikes back

By: Claude Solnik January 29, 2018

Facing new federal rules that limit state and local tax deductions, New York and California are considering options to give their residents a big federal tax cut. But experts said it's far from clear whether these strategies will survive challenges including a possible showdown in court or with the Internal Revenue Service.

President Donald Trump signed the Tax Cuts and Jobs Act of 2017, which the New York State Department of Taxation and Finance said would "have a disproportionate impact on the tax system and economy of the State of New York."

New York, according to the agency, already pays about $48 billion more to the federal government than it receives.

The new $10,000 limit on state and local tax deductions for federal income taxes would cost New York taxpayers $14.3 billion annually and end a system in place since modern federal income taxes launched in 1913, according to the agency.

"The law appears to target these 'donor' states that must raise state and local taxes to make up for this deficit," according to the department.

A Republican administration passed a limit that largely impacts states that voted Democratic in national, and in many local, elections.

"If you look at this tax cut, the states harmed the most are blue states," said Paul Graney, state and local tax leader for Marcum with Long Island offices based in Melville.

Gov. Andrew Cuomo has suggested that New York State residents could pay taxes in advance to benefit from the lack of limits on deductions. But that was just the beginning of a tax battle.

"The state deduction area has become a political football, with Gov. Cuomo firing the first salvo back in December authorizing localities to accept 2018 real estate taxes in 2017 before the new limitations took effect," said Charles Barragato, Melville office managing partner for tax services and Northeast regional leader of private client services for BDO USA. "The IRS answered with a release that spelled out that existing established federal tax rules for prepayments would still apply in determining a valid deduction."

New York now is considering drastically altering its method of taxation to help New Yorkers who could face higher federal taxes.

The state is eyeing the creation of a charity that New Yorkers could donate to in order to help the state, while obtaining state tax credits and federal tax deductions.

And it's considering implementing a new "employer compensation expense" tax that would essentially tax employers – rather than the employees.

"California is the only other state that has espoused any plan to try to do something like this," Graney said. "They put out the same two issues, looking at a charitable contributions and an employer tax base."

Barragato sees this as a way the states are trying "to mitigate or sidestep the effects of the new legislation's restrictions."

New York State argues that as the federal government changes longstanding rules regarding its treatment of state taxes, the states too can revamp their tax code.

"With the transformation of the federal tax system, it is incumbent on New York to consider adjusting its own tax structure accordingly," according to the state.

Secretary of the Treasury Steve Mnuchin, however, already has said the federal government will fight any attempts by states to shift or otherwise shelter residents' income from federal taxes.

"There is a question as to whether anything enacted by New York will pass federal scrutiny," Graney added. "New York can pass a law saying you can do this. The IRS can say, 'It's nice if you did this, but you're not getting the deduction.'"

The state is considering creating a special state charity that would be used to fund some state operations, providing tax credits against state taxes and a 60 percent charitable deduction on federal taxes.

"They would have to be set up to address some type of public benefit, public schools or upkeep of Central Park," Graney said. "They would have to have a specific function that this charity takes care of that would be covered by normal state funds."

The Internal Revenue Service could challenge this, which could lead to a challenge by someone with standing, such as a taxpayer. Or Congress could pass rules prohibiting deductions from such a charity.

"You make a contribution and get a percentage credit federally," Graney added. "If they disallow that, I don't know whether you'll get a dollar for dollar offset on your taxes. The danger is the IRS can look through these and say, at the end of the day, this is just a disguised income tax."

An employer compensation tax, where companies instead of employees are taxed on compensation, could reduce employees' wages on paper – by letting the state take the tax at the corporate level, instead of after it is paid as income.

"I think the federal government will say you tried to circumvent compensation and this additional amount is compensation and we'll tax it as such," Graney said. "They would say this is a taxable benefit you're receiving form the company."

If New York tries either of these approaches, they are likely to ignite a kind of tax war between the states and federal government.

“They could say you’re manipulating your tax statute to try to get a reduction in the federal tax being paid by your residents,” Graney added.

The speed with which New York rolled out its proposals also could mean they will lead to unexpected results.

“Many pundits suggest that the legislation was fast tracked, which has created unintended consequences,” Barragato said.

The Supreme Court, in theory, could decide what’s allowed, but might not weigh in on this issue, beyond whether the states’ actions are constitutional.

“The Supreme Court has for years made statements that they are not here to make tax policy, but to determine whether a statute is constitutional,” Graney added.

While the state’s efforts could lead to lower taxes, they also could just lead to a clash with the federal government that leaves everyone as is, if the measures don’t work.

“You would get the tax credit in New York, but you don’t get that federal deduction. So you’re back where you would be if you just paid your income tax,” Graney added. “You’re at status quo. Then there was no benefit to all the things going on. You’re paying the same tax federally.”

The limit on deductions won’t affect those who pay alternative minimum taxes, where you can’t deduct these taxes. Even filing taxes early to beat the $10,000 cap wouldn’t provide any help for people in that bracket.

“For taxpayers who will be subject to the alternative minimum tax in 2017, the prepayment of state income and real estate taxes provides no benefit,” Barragato added. “So this frenzy at year-end just created a significant amount of stress to taxpayers.”

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