EXECUTIVE SUMMARY

The Tax Cuts and Jobs Act (TCJA) makes significant changes to personal income and business taxes that will have major impacts on the residents and revenues of New York State and New York City. Decisive action is needed, yet the full implications of TCJA will not be known for quite some time. Given the imperative, the State and localities should rapidly implement responses to immediate issues, conduct sufficient analyses to design and implement responses where the issues are more complex, monitor the impacts of TCJA, and be nimble in adjusting policy going forward as warranted.

New York's leaders must focus on two main problems to protect the State and the City:

1. **The SALT cap makes New York less competitive for residents and businesses.** TCJA caps a taxpayer's deduction of state and local taxes (SALT) paid at $10,000 (SALT cap) and will increase taxes for many New Yorkers. In total, the SALT cap is estimated to cost New Yorkers between $9.5 billion and $15.3 billion in additional federal taxes, reducing the federal tax cut they would otherwise receive or, in many cases, resulting in a federal tax increase.

   The SALT cap also will increase the already large gap between New York's and other jurisdictions' state and local taxes. Neighboring states, such as Pennsylvania and Massachusetts, have lower and flat tax rates, and other jurisdictions do not have a personal income tax at all. For example, the SALT cap widens the gap between the cost of living in New York and Florida by $33,000 for a taxpayer earning $1 million, and a notable $423,000 for someone earning $10 million.

   This cost differential hurts New York's competitiveness as a place to live and conduct business, particularly for high income earners who make up so much of the tax base. New York State taxpayers earning more than $500,000 annually pay 49 percent—$21.0 billion—of the State's personal income taxes. Losing 2 percent of these taxpayers would reduce annual State income tax revenues by more than $421 million. A 2 percent reduction of similar New York City taxpayers would reduce City income tax revenues by more than $100 million. The widened cost differential may encourage New Yorkers to change their residences and discourage potential new residents from migrating here, both reducing tax revenue and forgoing the opportunity for New York to be the home of businesses these individuals control or would create.

2. **New York State tax conformity could drive $1 billion in unplanned State personal income tax and $109 million State business tax increases.** New York State and New York City use federal personal income tax definitions of adjusted gross income (AGI), exemptions, deductions, and credits as a base for calculating New York taxable income and liability. TCJA's changes are projected to result in an unplanned $1 billion increase in New Yorkers' State tax liability, and a $320 million unplanned increase in New Yorkers' City tax liability.

Despite the sweeping nature of the federal business tax changes, the direct impact on New York's businesses due to conforming to federal definitions is expected to total $109 million, including one-time revenue. The recurring increase would be less than 1.5 percent of corporate income tax receipts.

Recommendations

The potential negative impact of federal tax reform on New York has prompted a wide range of proposals, divergent opinions, and lively public debate. New York should not allow counterproductive federal tax policy to drive unsound State and local tax policy and should move quickly with solutions to address immediate problems, but also allow time for deeper analysis and experience for complex issues.

The following five strategies will help the State and the City mitigate the negative impacts of the SALT cap, address the unplanned tax increases, and set the stage for future action.

1. **Selectively decouple from federal definitions and continue to conform to others for at least one year to allow evaluation and additional reform.**

   The Governor has proposed selectively decoupling from all elements that drive the unplanned tax increase. The State should proceed with decoupling from the personal exemption, enhanced child tax credit, and the SALT cap since these would be relatively easy to administer and would relieve New Yorkers of $740 million of unplanned tax increases.

   Since conformity to the federal tax system makes filing easier for taxpayers and alleviates the State's burden of independently verifying itemized deductions, the State should not immediately decouple from the standard deduction, miscellaneous deductions, medical expense deduction, and alimony changes. This would result in a one-year net $300 million State tax increase that would primarily fall on higher income New Yorkers. The State should use this year to evaluate whether reforms could more effectively reduce unplanned tax increases while remaining conformed to the federal code.

2. **Blunt the impact of the SALT cap to maintain competitiveness.**

   2a. Create an optional Employer Compensation Expense Tax (ECET).

   The State should adopt a phased-in ECET, which would be optional for employers. The Governor proposed to implement an ECET on businesses on employee wages in excess of $40,000, phased up to a 5 percent rate over three years. CBC recommends that the ECET apply to wages above a higher salary threshold, perhaps $200,000, and phase up to a higher rate, perhaps 6.65 percent. Employees would receive a credit against their State income tax (which would increase their after tax income) and would have a lower gross salary, which would reduce their federal taxes. New York City should create an ECET as well, appropriately reflecting its tax rates.

If half those affected by the SALT cap were covered by the ECET, the Governor's proposal could offset 14 percent of the SALT impact. CBC's recommendation could save covered New Yorkers another $330 million. There are challenges to creating and implementing an ECET, particularly at the lower end of the salary scale. CBC recommends the higher wage threshold and tax rate since they would be easier to implement, better targeted to the main problem, and may garner higher uptake. The State should take the time to conduct sufficient analysis and obtain broad input. This does not need to be adopted with the State's budget; midyear adoption would still provide time for the ECET to go into effect for 2019.

2b. Create the opportunity for taxpayers to receive tax credits for charitable contributions for public education and health purposes.

The State and localities should create charitable education and health funds, to which taxpayers can make federal and State-deductible contributions and receive partial State and local income and property tax credits. Legislation to create these funds must establish a mechanism to ensure those funds are appropriated, expended, and reported in the budget appropriately and transparently.

These contributions can offset the impact of the SALT cap on high-income earners significantly: A filer earning $10 million and contributing $1.15 million to State and local health and education funds could save more than $300,000, primarily from lower federal tax liability. While beneficial, the viability of this strategy is uncertain since it may be challenged in the courts or by an adverse federal IRS ruling.

2c. Create a business tax on pass-through entities – an Unincorporated Business Tax (UBT).

Nineteen percent of the income of those with AGI more than $1 million is from partnership and S-corporation income; thus, a UBT would complement the ECET which applies to wage income. If all State and local taxes on partnership and S-corporation income were paid by the business and not the owner(s), a UBT could alleviate roughly 17 percent of the total SALT cap impact.

Designing a UBT will take time and will entail defining how income is sourced, expenses are attributed, whether or not it should be optional, and how payment to partners would be audited. A State UBT also would overlay New York City's current (and problematic) UBT, adding additional design and communication challenges. Any State proposal should be shared and vetted publicly to minimize unintended consequences.

3. Limit action on business taxes to the proposed technical fix.

The change proposed by the Governor ensures corporate taxpayers will not be allowed a deduction associated with deemed-repatriated income, since New York will not tax that income. The ease of administration outweighs the relatively minor unplanned tax increase caused by conformity to federal business tax definitions.

4. **Leverage this opportunity to consider further reforms.**

    4a. Consider reforming the estate tax to address New York's attractiveness to high-income households.

    Currently, New York is 1 of only 12 states that impose an estate tax. Reform could reduce rates, increase the exemption, fix the "cliff" that results in a greater than 100 percent marginal rate on certain estates, or repeal the tax entirely. Reforming the estate tax could help dissuade wealthy New Yorkers from leaving the Empire State for lower taxed locales and is of heightened importance given the impact of the SALT cap.

    4b. Control spending to reduce the need for high State and local taxes.

    Both New York State and New York City are high spending and high taxing jurisdictions. In some ways this reflects local preference for service provision; however, it also is a function of spending growth without increasing productivity or effectiveness.

    4c. Consider broader reforms to simplify the tax system.

    Federal tax reform is an opportunity for State policymakers to rethink New York's tax system, as was true after the 1986 federal changes. Opportunities to consider include broadening bases and lowering rates, shifting from reliance on the income tax, increasing federal conformity, and increasing fairness in the New York City property tax system.

5. **Monitor the effects of TCJA and State and City responses.**

    TCJA and the State and City responses will have predicted and unforeseen impacts that could be significant. Financial and legal interpretation will have substantial effects and behavioral and economic impacts will play out over time. The State and the City must monitor these effects, including resident migration, and adjust policy as needed to promote competitiveness, fairness, and good fiscal policy.

Conclusion

State and City leaders should take decisive action to maintain competitiveness and protect New Yorkers. These recommendations include steps needed to address the problems created by the TCJA and to signal that New York is a desirable place to live, work and run a business. The recommendations are, however, less than perfect. Given the challenges presented by TJCA, New York cannot let the perfect be the enemy of the practical and urgent. The State and localities should implement responses, monitor impacts, and make changes as needed. To the extent that responses face legal challenges or do not get significant uptake, the imperative to control spending and further reform the tax system increases.