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MEMORANDUM

TO: Governor Cuomo
Members of the Legislature

FROM: E.J. McMahon
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SUBJ: State response to federal tax reform

Last month's passage of the Tax Cuts and Jobs Act, the most sweeping rewrite of the federal tax code in 30 years, is both an opportunity and a challenge for the Empire State.

By curtailing the state and local tax (SALT) deduction, the new federal law will effectively increase the relative economic cost of New York's high state and local taxes, underscoring the need to reduce spending at every level of government.

Because New York State tax laws include numerous references to the federal Internal Revenue Code, the governor and the Legislature also will need to consider immediate changes to the state tax code. Many will be minor or technical in nature, especially on the corporate side. Because the federal law was enacted in a rush, it is likely to give rise to a plethora of tax avoidance strategies and consequences unforeseen by Congress. These, too, may ultimately require a state adaptation or response.

Rather than imitate the hasty congressional approach, the state should take time to carefully analyze choices and options for further reform of the state tax code. Here are five first steps for adapting to the new federal law by building on existing state policies:

1. Decouple from federal law where necessary to preserve the existing personal income tax (PIT) structure, including state itemized deductions.
2. Ensure the additional state "millionaire tax" rate is phased out on schedule at the end of 2019.
3. Follow through on and if possible accelerate the middle-bracket PIT cuts already scheduled for phase-in between 2018 and 2025.
4. Permanently enact the state's cap on local property taxes.
5. Complete the 2014 reform of the New York Estate Tax by eliminating the punitive "cliff" rates on the smallest estates still subject to taxation, recognizing that the new federal law will make New York more of an outlier in this area.[1]

Despite the loss of full SALT deductions, most middle-class New Yorkers will see their federal taxes drop over next few years. That's because, in addition to curtailing itemized deductions, the new law reduces tax rates, doubles the standard deduction, expands child credits and narrows the scope of the Alternative Minimum Tax, among other things.

The SALT change will most negatively affect a small but vitally important group of New York's highest earners, especially New York City residents already subject to the state's temporary "millionaire tax." Many of these taxpayers, who account for a disproportionately large share of state PIT revenues, will now face a higher combined marginal income tax rate despite the cut in their top federal rate.[2] They will thus have a significant added incentive to minimize their exposure to New York State taxes—a situation that should urgently concern the governor and the Legislature.

Major corporations doing business in New York will benefit from a sharp reduction (to 21 percent from 35 percent) in the federal corporate tax rate, although some of these corporations already had lowered their effective rates by using loopholes the law is now closing. In addition, taxes will be cut on business income passed through to owners, investors and partners in unincorporated firms. Note, however, that the pass-through business tax cut will <u>not</u> be available to the highest-earning participants in many of New York's most highly profitable professional services firms—including lawyers, physicians, creative consultants and investment advisors.

Last but not least, state leaders should flatly reject proposals that aim to preserve federal deductibility by shifting the state income tax burden from individuals to employers. They should also reject attempts to claw back federal tax gains from businesses deemed to be reaping a "windfall" from the new law. Embracing such approaches would only ensure that New York's business tax climate remains ranked among the worst in the country for years to come.

In the wake of federal tax reform, a line from the governor's 2011 State of the State is more resonant than ever: "We have to hold the line on taxes for now and reduce taxes in the future. New York has no future as the tax capital of the nation. Our young people will not stay. Our business will not come. This has to change."

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[1] For more, see the tax section of the Empire Center's "Checklist for Change: Policy Priorities for New York," at https://www.empirecenter.org/publications/checklist-for-change/

[2] For more details on how federal tax reform affects New Yorkers in top income brackets, see the Marginal Effective Tax Rates tables at https://www.empirecenter.org/publications/little-for-ny-in-latest-fed-tax-twist/ See also, "Exploring NY's top-heavy PIT base," Empire Center *Research & Data* brief, at https://www.empirecenter.org/publications/exploring-nys-top-heavy-pit-base/