

Bond Case Briefs

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State Tax Law Updates.

A number of states have recently proposed or passed new laws related to state-level taxation, some of which are taxpayer-friendly and some of which are expected to impose additional tax burdens on taxpayers. They vary in subject from efforts by states to mitigate the new federal limitation on the deductibility of state and local taxes to proposed changes to state income taxation of “carried interest.” This update reflects some of those recent proposals and laws.

Mitigation of Federal Limitation on Deductibility of State and Local Taxes

Recently, some states have reacted to the 2017 Tax Cuts and Jobs Act’s (TCJAs) limitation on the deduction of state and local tax (SALT) for US federal income tax purposes. Some of the proposed legislation, and new laws passed in Connecticut and New York, may benefit taxpayers by helping to mitigate the impact of \$10,000 limit placed on the federal deductibility of SALT.

In response to some of these proposals, the federal government has already announced, via Notice 2018-54, that it intends to propose regulations to disallow the use of such state-level workarounds for the SALT deduction limitation. The Notice specifically addresses proposals that allow taxpayers to receive SALT credits for certain transfers to funds controlled by state or local governments; however, it is likely that, with time, the federal government will work to disallow additional workarounds for the SALT deduction limitation.

Connecticut

On May 31, 2018 Connecticut Governor Dannel Malloy signed into law Connecticut Public Act No. 18-49 which imposes an income tax on pass-through entities (PTEs) effective retroactively as of January 1, 2018. The tax is imposed at a rate of 6.99% on the PTEs taxable income but is able to be offset by a personal income tax credit of 93.01% on the pro rata share of taxes paid by PTEs shareholders, partners, or members. Entity level taxes imposed on PTEs are generally not subject to the new SALT deductibility rules such that the PTE tax provides a PTE’s owners with an effective deduction against federal income tax without resulting in additional state level income taxes. The law applies to S corporations, partnerships, and limited liability companies (LLCs) treated as partnerships for federal income tax purposes. Furthermore, the law permits Connecticut municipalities to provide property tax credits to residents for amounts contributed to “community supporting organizations.”

New York

New York recently enacted an optional employer level payroll tax. If employers elect into this new payroll tax, based on wages in excess of \$40,000 paid to employees, then employees can take a credit for such payroll tax against their New York personal income tax liability. The election applies annually on a calendar basis and is limited solely to “employees” (rather than independent contractors, consultants, etc.). However, the administrative costs to implement the new tax, concerns regarding possible adjustments to employee compensation, and complex issues with non-resident employees might negatively impact how many employers actually make this election. If

elected the payroll tax has a three-year phase-in starting in 2019 with the following rate structure:

- 2019 rate – 1.5% of payroll expense
- 2020 rate – 3% of payroll expense
- 2021 (and subsequent years) rate – 5% of payroll expense

California

California has proposed three bills in order to help relieve state tax burdens of taxpayers:

- S.B. 227 would allow taxpayers to make charitable contributions to county-level education offices. These offices would issue certifications to taxpayers, distribute funds, and notify the California Franchise Tax Board (CFTB) of the contributions. For donations made under this bill, taxpayers receive a dollar-for-dollar state tax credit equal to 85% of the donated amount. On June 25, 2018 the bill passed the Assembly Revenue and Taxation Committee and is awaiting consideration at the Assembly Education Committee.
- S.B. 539 would expand an existing College Access Tax Credit to allow taxpayers to contribute to the California Educational Facilities Authority. Taxpayers can currently credit 50% of amounts contributed against state taxes owed. The proposed bill would increase that credit to 75% of amounts contributed. As of July 6, 2018, the Assembly Revenue and Taxation Committee has yet to hold a hearing on this bill.
- A.B. 2217 proposes that California nonprofits, public school districts, community colleges, and colleges and universities that participate in the Cal Grant program (qualified entities) can buy Golden State Credits from the California treasury for \$0.90. Taxpayers would then be able to purchase Golden State Credits from the qualified entities for \$1. In turn, taxpayers would receive a state tax credit equal to 80% of their purchase amount, which would be treated as a charitable donation. As of the end of June, this bill is awaiting a hearing in the Senate Governance and Finance Committee.

Treatment of Carried Interest

Under current federal law, a portion of income earned by investment managers called carried interest receives favorable tax treatment by being taxed at capital gains rates as opposed to the higher rates imposed on ordinary income. Certain states have enacted or proposed legislation to close this perceived loophole.

- New York: New York state bill A03554 intends to close the carried interest “loophole” through a “Fairness Fix” by imposing an additional 17% tax on such income, which is meant to bridge the gap between the highest federal individual rate of 37% and a capital gains rate of 20%. The proposal would also tax carried interest income of managers of hedge funds and other private investment funds as ordinary income at the state level rather than retaining capital gains treatment. However, even if the proposal becomes law, this re-characterization of capital gains income to ordinary income and carried interest fee will not take effect in New York unless Connecticut, New Jersey, Massachusetts, and Pennsylvania enact similar legislation.
- New Jersey: New Jersey Senate Bill 64 (S64) imposes a 19% additional tax on income from “investment management services.” Similar to the bill in New York, the New Jersey bill only becomes effective if New York, Connecticut, and Massachusetts enact similar legislation. S64 also contains a provision terminating the tax if Congress amends the Internal Revenue Code to repeal the present loophole at a federal level. On June 21, 2018 S64 was substituted by A3088, which passed on July 1, 2018, largely in the same form as S64, but substituting the 19% additional tax with a 17% additional tax. (P.L. 2018, ch. 45).
- Connecticut and Massachusetts: Each state, in 2017, proposed a 19% surcharge on carried interest

(referred to in the Connecticut bill as an “investment management fee surcharge.” Neither bill progressed to a vote, although similar legislation may be considered in the future.

- Pennsylvania: Pennsylvania has yet to propose legislation to address the taxation of carried interest.
- California: California has also proposed legislation to close the carried interest loophole by applying a state level tax to carried interest. The bill, Assembly Bill 2731, proposes California Revenue and Taxation Code section 17044 which would impose a 17% tax on income derived from an “investment management services interest” effective for taxable years beginning on or after January 1, 2018. California’s law is not contingent on any neighboring states. The bill has received initial approval, and has been re-referred to Committee on Rules as of May 29, 2018 for further consideration. In order to take effect two-thirds of the legislature needs to vote in favor of the bill.

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