

Recent Federal Tax Law Changes and Federal Tax Hot Topics for Municipalities and State Government, Including Remedial NYS Legislation

NYS Bar Association – Local and State Government Law Section

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Overview

- **Tax Reform: Tax Cuts and Jobs Act (TCJA)**
 - Elimination of Advance Refundings; Current Refundings still permitted
 - Tax Rate Changes
 - SALT Deduction Limit
 - NYS Remedial Action

- **Common Tax Issues for Tax-Exempt Bond Financings/Federal Tax Hot Topics**
 - IRS Priorities/Initiatives
 - Post-Issuance Compliance
 - Private Business Use



Advance Refundings

- **Background: Current vs. Advance Refundings**
 - Current refundings
 - Occur when bonds are refunded 90 or fewer days prior to the call date of outstanding bonds
 - Can be issued on a tax-exempt basis, with no limit as to how many times a current refunding can occur
 - Advance refundings
 - Occur when bonds are refunded more than 90 days prior to the call date of the outstanding bonds
 - Have always been disfavored (two sets of tax-exempt bonds are outstanding for a single project during the escrow period)
 - The 1986 Code permitted issuers a single tax-exempt advance refunding prior to the call date of a bond



Advance Refundings

- **How will this affect issuers going forward?**
 - Existing issues
 - Not as much of a problem now because of rising interest rate environment
 - Since the Fed started raising short-term rates a few years ago, municipal advisors have generally been encouraging clients to aggressively (advance) refund anything possible
 - Did not expect to see as many this year



Individual Income Tax Rates

- Old rate structure temporarily replaced with new lower rate structure
- The maximum individual tax rate is reduced to 37% (previously 39.6%)
- 3.8% Net Investment Income Tax retained (applies to adjusted gross income over \$250K joint or \$200K single)
- Capital gain and qualified dividend rates remain unchanged
- The lower rates for individuals will sunset for tax years beginning after December 31, 2025



U.S. Corporate Tax Rate

- Permanently reduced from 35% to 21%
- Corporate AMT repealed
- Reduced corporate rate diminishes the impact of double taxation to shareholders
 - The combined 21% corporate rate and 23.8% dividend rate (inclusive of 3.8% Net Investment Income Tax) should result in an effective combined tax rate of 39.8% on dividends paid to individuals, compared to the top federal income tax rate on ordinary income of individuals of 37% (40.8% if the 3.8% Net Investment Income Tax applies)
- State and local tax deduction allowed



STANDARD DEDUCTION AND PERSONAL EXEMPTION

- Old law was \$12,700 for married taxpayers filing jointly, and \$6,350 for single taxpayers
- Temporarily increased to \$24,000 for married taxpayers filing jointly, and \$12,000 for single taxpayers
- Deduction for personal exemptions suspended
- Miscellaneous itemized deductions suspended
- These changes will sunset for tax years beginning after December 31, 2025



SALT Deduction

- State and local tax ("SALT") deduction temporarily limited to an aggregate deduction of \$10,000
- Limitation does not apply to taxes paid or accrued in carrying on a trade or business or an activity engaged in for profit (e.g., property taxes paid on rental real estate)
- Precludes a 2017 deduction for certain prepayments of 2018 state income taxes
- This deduction limitation does not apply to tax years beginning after December 31, 2025.



NEW YORK'S RESPONSE

- Before the Passage of the Act: Outrage
- After Passage: Efforts to protect New York taxpayers
- Objective: Allow New Yorkers to convert payments for which deductibility is now limited into other (fully deductible) types of payments
- At State Level: State tax payments (with limited deductibility) recharacterized as charitable giving (with essentially unlimited deductibility)
 - New “charitable gifts trust fund” formed
 - Accepts donations for improving health care and public education in NYS
 - Donations are claimed as charitable donations
 - In the next year, taxpayer can claim a NYS tax credit equal to 85% of the donation



NEW YORK'S RESPONSE

- **At Local Level: (Counties, Cities, Towns, Villages and School Districts): Charitable Donations in Lieu of Property Taxes**
 - Localities have option of establishing local “charitable gift reserve funds” (and offering related property tax credits to incentivize donations)
 - Donations support education, health care and other charitable purposes
 - Local government must adopt a local law or resolution to participate
 - May also authorize a real property tax credit of up to 95% of the value of the donation
 - May set limits on the donation amount or the related tax credit percentage
 - Must establish a procedure for making contributions (acknowledgment form required)
 - Donor/property owner presents tax credit claim form to tax collector (on or before the tax deadline)
 - Tax collector furnishes tax credit on the spot
 - There are refund scenarios if claim form is presented after the tax deadline (or in a mortgage escrow scenario)



NEW YORK'S RESPONSE

▪ **At State Level: Employee Income Taxes Converted to Employer Payroll Taxes**

- The Employer Compensation Expense Tax, TL §§ 850-857
- Idea here is for NYS to get more taxes from employers (who can still fully deduct them as business expense) than from employees (who may not be able to fully deduct them now)
- Employer has option of joining the "Employer Compensation Expense Program" (ECEP)
- 5% additional tax paid by employer on all payroll over \$40,000 per employee (so NYS gets a lot more money)
- Employer theoretically reduces wages (in light of essentially "paying taxes on behalf of the employee")
- This flood of new money is then offset by a new tax credit for the employee, so this is how the employee is made whole for the pay cut
- Opt in election must be made by the employer by December 1 and is effective for the next tax year
- More guidance coming from NYS.



IRS Response: Notice 2018-54

▪ **IRS Notice 2018-54**

- May 23, 2018: IRS warns taxpayers that substance over form will control for federal tax purposes and that regs will be proposed to address this issue

▪ **The proposed regs will:**

- "make clear" that the requirements of the Code, based on substance-over-form principles, govern the federal income tax treatment of the transfers; and
- assist taxpayers in "understanding the relationship between the federal charitable contribution deduction and the new statutory limitation" on the SALT deduction.

- ***Substance over form = IRS will not recognize a charitable contribution deduction that is a disguised SALT deduction.***



IRS Response: Proposed Regulations

▪ **Proposed Regs shut down SALT workaround**

- when a taxpayer receives or expects to receive a state or local tax credit in return for a payment or transfer to an entity listed in Internal Revenue Code Section 170(c), ***the receipt of this tax benefit constitutes a quid pro quo that may preclude a full deduction under Code Section 170(a).***
- Code Section 170(a)(1) generally allows an itemized deduction for any "charitable contribution" paid within the tax year.
- "Charitable contribution" is defined as a "contribution or gift to or for the use of" any entity described in Code Section 170(c)(1), including a contribution or gift to or for the use of a State, a possession of the U.S., or any political subdivision of the foregoing, but only if the contribution or gift is made exclusively for public purposes.
- The Supreme Court has held that a charitable contribution must be a transfer of money or property without adequate consideration—that is, ***without the expectation of a quid pro quo.***
- The regulations further provide that no part of a payment that a taxpayer makes to an organization that is in consideration for goods or services is a contribution or gift unless the taxpayer (i) intends to make a payment in an amount that exceeds the fair market value of the goods or services; and (ii) makes a payment in an amount that exceeds the fair market value of the goods or services.



IRS Response: Proposed Regulations

▪ ***What does this mean?***

- a taxpayer who makes payments or transfers property to an entity eligible to receive tax deductible contributions would have to reduce its charitable deduction by the amount of any state or local tax credit the taxpayer receives or expects to receive.
- The state and local tax credit is the ***quid pro quo.***

- **Example:** if a state grants a 70% state tax credit and the taxpayer pays \$1,000 to an eligible entity, the taxpayer receives a \$700 state tax credit. The taxpayer would have to reduce the \$1,000 contribution by the \$700 state tax credit, leaving an allowable contribution deduction of \$300 on the taxpayer's federal income tax return.

▪ ***What's next?***



Common Federal Tax Issues

- **Tax Exempt Bonds:** Interest excluded from gross income for federal tax purposes.
 - Federal tax exemption of interest on bonds is conditioned on satisfying the tax requirements throughout the term of the bond.
 - Two Main Types:
 - Governmental Bonds
 - Private Activity Bonds

- **IRS Priorities For Tax-Exempt Bond Programs in 2018**
 - Non-Qualified Use: examine sales of financed facilities and/or excessive private business use
 - Voluntary Compliance Agreement Program (VCAP)- self-reporting of possible tax violations

- **Post Issuance Compliance:** emphasis is on implementation of procedures. Are the procedures effective?



Common Federal Tax Issues

- **Private Business Use Test**
 - No more than 10% of the bond proceeds may be used for private business use; and
 - No more than 10% of the debt service on the bonds may be derived from private payments of private security.

- **Examples of Private Business Use:**
 - Lease of a building to a nonprofit/501(c)(3) organization
 - Sale of an unused building
 - Food service contract for cafeteria services
 - Naming rights



Thank You!

QUESTIONS?

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