



ISSUES IN BRIEF

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“Payroll Tax”

Governor Cuomo proposed “employer compensation expense tax” (ECET), or “payroll tax”, was adopted as part of the state’s FY 2019 budget (See S.7509-C, Part MM). This measure is intended to mitigate the adverse impact of federal tax reforms on some New York State taxpayers. The idea is to substitute a tax that is assumed to retain full federal deductibility (an employer payroll tax) for one whose federal deductibility is now limited (the state’s personal income tax, or PIT, is included in the new federal cap of \$10,000 on deductibility of all aggregate state and local taxes – or SALT -- paid).

Key elements of this new legislation:

- Employer participation is voluntary, and employers would be allowed to “opt-in” to the program on an annual basis (by December 1st);
- The employer would pay a flat payroll tax on each employee’s wages over \$40,000, at a rate of 1.5% in 2019, 3% in 2020 and 5% in 2021 and thereafter;
- Employees would continue to pay the state PIT on their total salary, but would receive a state PIT tax credit based on the payroll tax their employer paid on their wages.

The intent of this measure is to retain income in New York by reducing federal tax payments caused by the new cap of the deductibility of state and local taxes on your federal tax returns. It is designed to leave both the employee and employer with the same net after-tax income as they would have had without the federal SALT deduction cap, while also avoiding a loss in tax revenues to the state. This would be achieved at the expense of the federal government, which would see a reduction in their tax revenues compared to their post-reform projections.

However, even with full federal deductibility of this new employer payroll tax, if employers simply paid the ECET it would result in an increase in employer costs, and lower after-tax net income. Therefore, the proposal anticipates that wages would be modified over time to reflect the cost of the ECET, which is one of the reasons the ECET rate is phased-in over three years. While the proposal would prohibit employers from directly deducting the cost of the ECET directly from employee’s paychecks, as is done for other existing payroll taxes such as FICA and unemployment insurance, employers would be allowed to adjust pre-tax wages.

Moreover, the ECET proposal includes a new state-level tax credit for employees that is intended to help offset any loss in pre-tax wages. That credit, coupled with reduced federal tax liability that comes from lower wages, is intended to result in employee after-tax income that is as much as, or in some cases higher than, such income prior to the federal cap on SALT deductions.

Presumably, employers would opt into this program as a means to preserve their employee’s after-tax income. However, employers will likely consider other factors as well before opting in, including:

- The increased costs of administering the payroll tax and monitoring compliance;
- Their willingness and ability to modify payrolls, especially for unionized workers;
- The impact of wage reductions on other employee benefits, such as pensions, 401K matches; and others; and
- The degree to which the employer’s workforce would already be getting a federal tax cut *without* any state-level change.

This payroll tax proposal raises other tax policy issues as well.

- Will Congress or the IRS act to limit the federal deductibility of employer payroll taxes, since Congress adopted the SALT deduction cap to pay for other elements of federal tax reform?
- With the state facing significant budget deficits over the next several years, will future Governors or Legislatures adopt an increase in the payroll tax rate to help balance the budget?
- Will this be an effective measure to keep those high income earners hit hardest by the SALT deduction cap from leaving New York, since the majority of their income comes from non-wage sources, primarily capital gains?
- How does the state address the impact of SALT deduction caps on employees of state and local government, and non-profit organizations, whose employers have no federal tax liability against which a payroll tax can be deducted?

This new provision of the Tax Law is effective immediately, and employers have until December 1 to opt into the program for the 2019 tax year. The state Department of Taxation and Finance is developing guidance documents on how the program will work, and on the obligations of participating employers.

We welcome your questions and comments.

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