The Tax Cuts and Jobs Act (TCJA) limited the deduction for state and local taxes (SALT) to $10,000 for federal tax purposes. For those living in states that impose a personal income tax, this limitation may result in an increase in federal tax if their deductions for property taxes and income taxes paid to states and localities exceed the $10,000 limit.

New York State enacted the Employer Compensation Expense Program (Payroll Tax) as a new Article 24 of the Tax Law as part of its 2018-2019 Budget (Part MM). This is the first response by a state attempting to work around federal tax reform.

This program imposes voluntary tax on employers based upon the wages paid to employees in excess of $40,000 per year. An employer would make an annual election to participate in the program by Dec. 1, 2018, for the succeeding calendar year (beginning in 2019). Under the program, the employer would pay tax, at the rate of one and a half percent for 2019; three percent for 2020; and five percent for 2021 and subsequent years on the wages of **all** employees in excess of $40,000 and include the Payroll Tax remittance with the withholding tax filings. The employee would be entitled to take a credit for the amount of tax paid by the employer on his/her salary thereby reducing the New York State and local income tax. The law prohibits the employer from deducting the amount of the employer's payroll tax from the wages or compensation of an employee: "An employer cannot deduct from the wages or compensation of an employee any amount that represents all or any portion of the tax imposed on the employer under this article." Tax Law §853. While this provision prohibits deducting the Payroll Tax from an employee's wages, it does not address a reduction in compensation to arrive at net compensation to account for the tax savings that the employee receives.

For example, an employer electing to participate in the program for 2019 would pay $15,000 of tax for an employee with wages of $1,040,000 per year (the amount in excess of $40,000 x one and half percent). The $15,000 paid by the employer would be available to reduce the employee's state and local income tax by $15,000, saving the federal tax on that amount (up to the highest marginal tax rate of 37 percent). Then the employee's salary could be reduced by $15,000 for a net compensation of $1,025,000. In 2020, the employer's payroll tax would rise to three percent of the $1 million in excess of $40,000, making $30,000 available as a credit; in 2021, the employer would pay $50,000, with that amount available as a credit reducing their state and local income tax. This credit is available to nonresidents of New York paying tax based upon New York source wages as well as residents. The federal tax savings would range from $5,550 for 2019; $11,100 for 2020; and $18,500 in 2021 in this example. The New York State tax savings would be about $1,350 in 2019; $2,700 in 2020; and $4,500 in 2012. New York City residents would save about $600 in 2019; $1,200 in 2020 and $2,000 in 2012. There would be no tax benefit for employees taking the standard deduction even though the employer incurs the Payroll Tax on wages in excess of $40,000.

Since many New York taxpayers incur state and local taxes far in excess of the $10,000 limitation including property taxes as well as income tax, the relief provided by the Payroll Tax could be significant.

However the Internal Revenue Service will react to this “work around” of the SALT limit is uncertain. There are substantial risks to both the employer and the employee depending upon the IRS’ response to this and other states’ work around. Until the IRS issues guidance the degree of risk is unknown.

This tax is set to go into effect as of Jan. 1, 2019, with employer elections to participate due by Dec. 1, 2018. Employers with the ability to adjust compensation to arrive at a net salary equivalent to the original wages plus the credit for the Payroll Tax must carefully consider the effects of their opting into this system and weigh the risks of participation. Consultation with tax lawyers and accountants is important before jumping into these untested waters.