SALT Cap Enforcement May Mean Years Of Tax Limbo

David M. Kall | Friday, May 25, 2018

Law360 (May 24, 2018) -- The U.S. Treasury Department is positioning itself to challenge states' attempts to help constituents bypass the new federal limit on tax deductions, and taxpayers can expect years of uncertainty if the two sides — each facing difficulties justifying their viewpoints — go to court.

Since the Tax Cuts and Jobs Act was enacted in December and placed a $10,000 cap on the federal deduction taxpayers can get for paying state and local taxes, high-tax states such as New York and New Jersey have approved measures that essentially swap nondeductible taxes with payroll taxes and charitable contributions that still can be deducted on federal returns.

Without actually stating a concrete position on whether such charitable contributions in lieu of taxes will be eligible for a deduction, Treasury and the Internal Revenue Service warned taxpayers Wednesday that federal law controls how payments can be characterized for federal income tax purposes.

The lack of further clarity from Treasury indicates the federal government may be struggling to reconcile its acceptance of similar state programs that existed before the TCJA with its doubts over these new regimes, according to Daniel Rosen, an attorney in Baker McKenzie's tax practice.

It "suggests to me that there must be a hard struggle within the IRS as to how they're going to be able to move away not only from their own position that they've stated previously on this issue, but also the case law and the broader impact on charitable contributions," Rosen said.

There are dozens of programs that have existed for years across the country in states including Iowa, Missouri and Georgia, where taxpayers can get a credit for monetary or real property donations for conservation purposes. One way the IRS and Treasury can delineate between these programs and the new ones cropping up is by relying on the intent behind charitable contributions, according to Jamie Yesnowitz, a state and local tax principal at Grant Thornton LLP.

"The older regimes ... seem as though there is more of a donative intent on behalf of the taxpayer, and the tax benefit they are getting is a byproduct of the system. Here, with regard to the charitable contribution regime, it's not a byproduct. It's the reason," Yesnowitz said.

"Donative intent" — the determination of whether a donation was made with a charitable mindset and without expecting a personal benefit — is likely to be a difficult hurdle for states to overcome.

David Kall, chair of the multistate tax practice group at McDonald Hopkins LLC, said it would be difficult for states to classify taxes as charitable contributions if taxpayers choose not to donate and then the states assess those taxes anyway.

"At the end of the day, a taxpayer is expecting something in return by making that contribution to the state," Kall said. "Were these intended to be outright gifts with no strings attached or was there a quid pro quo where they're making the contribution with the expectation that they were going to get something in return?"

States could potentially argue that they have created a valid charitable organization and that there is no guarantee that funds going to the charity will benefit donors. For example, donations made in lieu of property taxes could feasibly be redirected to a county different than the one where the donor lives, Kall said.

States could also have trouble proving they have the authority to sue the federal government over any action taken to thwart their end runs around the SALT deduction limit, which both New York

and New Jersey have threatened to do.

“There's really old case law out there that basically says Congress has the ability to establish and remove itemized deductions in theory, and it's not a state issue. It's a federal income tax issue, which really has nothing to do with state sovereignty,” Kall said.

But the IRS may also be restrained in its ability to control these new state programs. Any new rules imposed on these programs is likely to affect charitable contributions in general, and the IRS’ ability to administer the respective deduction, Rosen said.

“Can you imagine how difficult, if not impossible, it would be for the IRS to administer a charitable contribution deduction based upon whether the donor had a tax avoidance motive?” he said.

While the IRS has said that it will evaluate charitable contributions being made to states in reaction to the new deduction limit by looking at the substance behind these contributions, Rosen pointed out that the substance-over-form doctrine doesn’t typically look for a tax avoidance motive.

“When you look at ... what the courts have said about substance over form, it's an evaluation of the objective economic realities of the transaction, not the subjective motivations of the transactional participants. So I don't see how substance over form gets the IRS to where they want to go,” he said.

Depending on the specifics of each state program that may be questioned, the fact that both the federal and state governments appear to have legitimate arguments they can make and stances to lose could mean that taxpayers, who may begin claiming charitable contribution deductions on their tax returns next year, could be left waiting for years for potential IRS audits and lawsuits to be resolved.

“I think that we are certainly in for years and years of litigation on this front,” Yesnowitz said. “Most unfortunate of all, it could be years of uncertainty with respect to the taxpayers that try to use these state laws.”

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Team member bio