SALT deduction cap will harm legacy cities encourage tax games

David M. Kall | Thursday, December 28, 2017

As it currently stands, federal tax rules allow individuals who itemize their deductions to deduct the full amount of their state and local tax (SALT) income tax payments from the taxable income on their federal returns. But the new regimen, the Tax Cuts and Jobs Act set forth in HR 1, which President Donald Trump signed into law on Dec. 22, 2017, limits the deduction for income, sales or property taxes to $10,000, or $5,000 in the case of a married individual filing a separate return, for tax years 2018 through 2025.

There are many reasons to dislike this development, but one that has not been widely covered is the harm it does to legacy cities. Legacy cities, according to Matthew J. Rossman, a Case Western Reserve University School of Law professor, are “places in the Northeast and Midwest where industry and manufacturing once flourished and supported thriving residential communities.”

In his Dec. 15, 2017 guest editorial in Cleveland.com, Rossman explained that “[a] slew of economic, political and social forces dramatically changed the fortunes of these cities, causing them to bleed employers and good-paying jobs, lowering their standard of living and reversing population growth.” This depleted the tax base, because affluent residents moved to more prosperous areas. In turn, the legacy cities were left to struggle with less money to “support aging public infrastructure, deteriorating housing stock and poorer residents…all the while striving to reinvent themselves to compete in the 21st-century economy.”

As it is, legacy cities usually impose higher local tax rates than newer suburbs and exurbs, and their existence is part of what makes upper-middle-income households in high-tax states "the biggest losers" of the new SALT deduction limits. "They earn enough and live in expensive enough houses to make the proposed doubling of the standard deduction an inadequate trade for losing much of their SALT deduction."

Rossman is concerned that citizens will simply move to avoid the increased tax burdens. "Assuming that people take into account local taxes when deciding where to live (and, honestly, do you know many people who don't?), scaling back SALT in concert with doubling the standard deduction may very well choke demand for housing in legacy cities."

We have addressed this question a number of times this year. In our most recent article, just two weeks ago, we asserted that the idea of people moving just to avoid higher taxes has been a persistent, if debunkable myth, but that the real estate company Redfin's 900-person survey may reveal a new mood. 33 percent of those interviewed said they are "seriously thinking" about "shifting their home searches to locations where they will be less exposed to tax increases" if Congress eliminates the SALT deduction

Rossman also worries about the domino effect of the SALT deduction cap on legacy cities. Even if a tax credit for people who buy homes and live in legacy cities would be a better mechanism for mitigating escalating housing costs in legacy cities, "simply casting aside a century-old deduction like SALT without considering the resulting impact on U.S. communities and neighborhoods is short-sighted and haphazard."

Rossman is not the only one who fears the impact of the new SALT deduction cap. An early December article on Citylab.com conceded the regressive nature of the deduction in the first place, but charged that eliminating it "could be even worse for America."

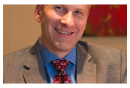
Possible solutions

Citylab agreed that high-tax areas will be hurt, but suggested that the hardship would actually be more widespread: "cities, which lev[y] taxes of their own to pay for goods and services that their constituents need, are also likely to see a negative effect on their bottom lines….[the cap would have a] systemic impact on cities and states, which must navigate the politics of raising local revenue from the same residents who also pay federal taxes**."**

To cope, Citylab pointed out that cities could start to depend on other revenue sources, like licensing fees and fines, though this is a solution that is both regressive and not especially effective. In California, one-third of taxpaying households, or 6 million people, will feel the pinch from the SALT deduction cap.

A Dec. 19, 2017 report titled The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the New Legislation, which contains the insights of a number of tax scholars, practitioners and analysts, listed several additional potential work-arounds for states, such as using employee payroll taxes in place of a state income tax. The employer would be subject to this tax, who would still be able to deduct the taxes. Another is the imposition of a business franchise tax on pass-through entities; states could link up the franchise tax system to their individual income tax systems, for instance, which would reduce individual income tax liability based on franchise tax payments.

In the end, the report claims, the complex rules set forth in the new tax law "will allow new tax games and planning opportunities for well-advised taxpayers, which will result in unanticipated consequences and costs."



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