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Tax Reform: IRS takes aim at state efforts to circumvent SALT deduction cap

David M. Kall | Thursday, June 7, 2018

The Treasury Department and the Internal Revenue Service recently issued a notice stating they intend to address state efforts to circumvent the new federal limit on individual deductions for state and local taxes (SALT). The new limit, put in place by the Tax Cuts and Jobs Act of 2017, is $10,000 for most taxpayers. (For married taxpayers who file separately, the limit is $5,000.)

The SALT deduction has existed in some form since the inception of the federal income tax in 1913. It is available to taxpayers who opt to itemize their deductions, rather than take the standard deduction. Before the new limit was added, taxpayers generally could deduct the full amount of their payments of state and local property taxes, as well as either income taxes or general sales taxes.

From the perspective of state and local governments, the SALT deduction is an indirect federal subsidy that allows them to raise tax revenue at a lower net cost to their residents. (As an example, if state income taxes increase by $100 for a taxpayer in the top 37percent federal income tax bracket who takes the SALT deduction, the deduction reduces the taxpayer's federal income tax by $37, so the net cost to the taxpayer is only $63.) But the value of the subsidy is not evenly distributed among the states. As taxpayers' incomes increase, they generally have higher state and local tax liabilities and are more likely to itemize their deductions. The deduction also is more valuable to taxpayers in higher income brackets, in terms of the reduction in federal tax for each dollar deducted. As a result, the subsidy disproportionately benefits states with large numbers of high-income residents. The subsidy also is of greater benefit to jurisdictions that impose high taxes.

STATE CHARITABLE CONTRIBUTION WORKAROUNDS

The new cap on the SALT deduction reduces the value of the federal subsidy to state and local governments, and does so in a way that disproportionately affects states with high taxes and many high-income residents. Not surprisingly, governors and lawmakers in these states have denounced the cap. New York Gov. Andrew Cuomo promised that "New York will not stand idle while the federal government takes aim at the economic heart of our communities and takes from the hardworking men and women of this state to benefit this country's wealthy and corporations." California Senate leader Kevin De León struck a similar tone, asserting that the "tax plan gives corporations and hedge-fund managers a trillion-dollar tax cut and expects California taxpayers to foot the bill."

In response to the cap, several states have considered workarounds that are intended to convert tax payments into deductible charitable contributions. These proposals would allow residents who contribute to a fund affiliated with a state or local jurisdiction to take a deduction or credit against their state or local tax liability. Then, on their federal tax returns, the residents would deduct the contributions as charitable contributions, rather than as tax payments.

New York has adopted a workaround, as we previously reported, as have Connecticut and New Jersey. In California, two workaround proposals are pending: one passed the state Senate in January, and the other passed the Assembly in May.

FEDERAL RESPONSE

The May 23 notice announces that the Treasury Department and the IRS intend to propose regulations that address the federal income tax treatment of payments made by taxpayers under these state workaround proposals.

The notice observes that state legislatures have responded to the SALT deduction cap by considering or adopting "legislative proposals that would allow taxpayers to make transfers to funds controlled by state or local governments, or other transferees specified by the state, in exchange for credits against the state or local taxes that the taxpayer is required to pay. The aim of these proposals is to allow taxpayers to characterize such transfers as fully deductible charitable contributions for federal income tax purposes, while using the same transfers to satisfy state or local tax liabilities." Describing the workaround proposals as "state efforts to circumvent the new statutory limitation on state and local tax deductions," the notice cautions that "taxpayers should be mindful that federal law controls the proper characterization of payments for federal income tax purposes."

According to the notice, the proposed regulations will make clear that federal law, "informed by substance-over-form principles," governs whether a payment is treated as a charitable contribution or as a tax payment for purposes of federal income tax.

UNCERTAIN FUTURE FOR WORKAROUNDS

According to the Tax Foundation, the state workaround proposals appear to "face serious headwinds" under existing federal law. One potential obstacle is that, as explained in IRS Publication 526, a charitable contribution is not deductible to the extent of the value of any benefit the taxpayer receives as a result of making the contribution. If a taxpayer receives a deduction or credit against state or local tax liability as a result of making a contribution, the IRS very well could conclude that the "contribution" is in substance a tax payment.

Already, uncertainty over the IRS notice has stalled the progress of workaround legislation in Illinois. After the notice came out, the state Senate approved a version of the proposal, but lawmakers in the House effectively blocked further action. Crain's Chicago Business reports that, under normal procedures, lawmakers will revisit the proposal this fall at the earliest.

The fate of the various state workaround proposals should become clearer when the proposed regulations are released, which the IRS says will be "in the near future." In the meantime, residents of states that have adopted workarounds should tread carefully.

David M. Kall

Team member bio