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State Tax After TCJA: Blue States' Deduction Strategies

By **Gary Botwinick** (May 1, 2018, 2:07 PM EDT)

The passage of the Tax Cuts and Jobs Act has sent some states scrambling to amend their own tax laws. In this special series, tax attorneys analyze the ongoing effects of the TCJA on various aspects of state tax law.

Gary Botwinick

What do you do when it seems that Washington is out to get you? If you are a lawmaker or governor in New York, California, New Jersey or any of several other blue states that relies on a significant income tax or real estate tax to pay your state's bills, you get creative.

That is exactly what is going on today in these states due to the the Tax Cuts and Jobs Act, P.L. 115-97, and the significant limitations that it imposed on the deductibility of state and local taxes for federal income tax purposes. According to the Tax Policy Center, "[s]tate and local income and real estate taxes make up the bulk of total state and local taxes deducted (about 60 percent and 35 percent, respectively), while sales taxes and personal property taxes account for the remainder. The state and local tax (SALT) deduction is one of the largest federal tax expenditures, with an estimated revenue cost of $96 billion in 2017."

So when Congress and the White House were looking for a way to pay for the significant tax cuts under TCJA, the SALT deduction became an easy target. Under TCJA, the SALT deduction is now limited to only $10,000. It probably didn't help their cause that the states where this burden would be felt the most were considered "blue states," based upon their voting histories in recent presidential and congressional elections.

The states have considered several creative ways to mimic the result that would have been achieved by the SALT deduction had it remained. Three are clever changes to states' tax systems, and one is filing suit in federal court. It is unclear whether any of these methods will be successful, but hey, you can't blame them for trying.

The three legislative fixes are: (i) substitute charitable donations to organizations established to

accomplish a similar state purpose for state and local tax payments; (ii) substitute an enhanced state payroll tax for direct tax payments; and (iii) impose an entity-level tax on pass-throughs. Additionally, New York's governor recently announced that New York, New Jersey and Connecticut intend to file a federal suit challenging the constitutionality of TCJA’s significant restrictions on the SALT deduction.

So how do these proposed fixes work, and what are the chances that one or more will succeed?

Charitable Donations for Government Purposes

The simplest proposed fix is to substitute charitable deductions for state and local tax payments. Generally, it works like this: A taxpayer could make a voluntary charitable contribution to an entity or fund established by a state or local government that performs some function that the state or local government would otherwise have paid for from taxes. The entity might use this money to subsidize teacher’s salaries, improve school property or even buy books and computers.

The contribution would entitle the donor to a credit on her state and/or local taxes, and would allow her to claim a charitable deduction on her federal income tax return. Since charitable contributions are still deductible under TCJA, a nondeductible payment (state and local taxes) is effectively converted to a deductible payment (charitable contribution).

So will it work? There are serious challenges inherent in this technique. Congress could act and prohibit charitable contributions of this type. The Internal Revenue Service, even in the absence of congressional action, could issue regulations specifically prohibiting these deductions, which would, of course, lead to an inevitable challenge of the regulations as being beyond the IRS’ authority.

The IRS could also take the position that the contribution is not a charitable contribution at all — it is really a tax payment by another name. There is a difference between a contribution to a fund that produces a specific civic benefit that the government is not otherwise going to perform, and a contribution to a fund to perform a government function that the government would otherwise pay for anyway, or would pay to the extent that contributions are insufficient to satisfy the need in full.

Another significant hurdle is that a taxpayer is generally not entitled to a charitable deduction if he receives something of value in exchange — a quid pro quo. Is a dollar-for-dollar credit against state and local taxes a quid pro quo contribution, thus rendering the contribution nondeductible? We will see soon enough since, on April 12, New York Gov. Andrew Cuomo signed a budget bill that allows for receipt of credits for certain charitable contributions to entities that satisfy some governmental purpose. It is anticipated that New Jersey, Illinois and California will shortly follow with similar legislation.

Employer Payroll Tax

Another proposed fix is more complicated, but probably more likely to stand up. New York’s new law has incorporated this approach in addition to the charitable contribution concept discussed above. The idea is to allow employers to voluntarily elect into a new state payroll tax for employees, effectively shifting the tax burden to the employer (who can then deduct the cost as a business deduction) and away from the employee.

Of course, the employer electing into this system would presumably reduce the salary of the employee by the amount of the payroll tax. In effect, the employer is paying the tax for the employee by reducing

the employee's compensation. Sounds like a good idea, until you think about what happens for employees who live in New Jersey or Connecticut who commute into New York for work. It would require all three states to enter into some sort of compact for it to work in those circumstances.

It would also affect other matters such as reducing the compensation amount available for determining eligibility for retirement contributions and the like. Employees' unions would need to renegotiate contracts. Also, are employees going to even understand what the employer is doing? They will certainly understand that their wages are reduced.

The one benefit that this method has over the charitable contribution method is that this is much more consistent with the law. While the IRS could try to take the position that this method is really nothing more than an end run around the limitation of the SALT deduction, since it is consistent with the law, such an effort is unlikely to be successful.

The Connecticut Plan

The plan that Connecticut has been considering is an alternative to the two techniques mentioned above. This plan would impose an entity-level tax on the net income of pass-through businesses. This would be coupled with an individual income tax credit for the entity's members that would offset the entity-level tax. Since businesses are not subject to the same SALT deduction limitation as individuals, the entity-level tax will reduce the income tax of the owners of the pass-through entity and leave the owners in the same position as if there were no limit.

What makes this method so appealing is that it is the most likely to withstand any attempt by the IRS to disallow it. Here, the state is simply shifting the source of its tax base from individuals to entities.

The Connecticut plan also has the additional benefit of ensuring the collectibility of the tax on Connecticut-sourced income from out-of-state owners. But what happens to those owners on their resident state tax returns? If a member paid individual income taxes on the Connecticut-sourced income, she would be entitled to a credit in New York. Would New York give her the same credit for the dollars that were now shifted to the entity level?

Another problem is that this technique only benefits business owners, and does nothing for wage earners. Nonetheless, there is no restriction on any state implementing more than one method, as evidenced by New York's dual-method remedy. Connecticut plans to offer a voluntary charitable donation plan like New York's new law, in addition to the entity-level tax on pass-throughs, that would be available to wage earners and all other taxpayers.

The Federal Lawsuit Avenue

New York, New Jersey and Connecticut have been discussing teaming up to file a constitutional challenge to the SALT deduction limitation under the TCJA. In January, Gov. Cuomo, appearing on a radio show with New Jersey Gov. Phil Murphy and Connecticut Gov. Dan Malloy, said about the SALT deduction limitation that "[n]ot only do we find it philosophically repugnant and practically damaging, but legally, we believe there is a very strong argument that it's unconstitutional."

He further stated, "[w]e're going to be working together to form a multistate coalition that will challenge this in court." Yet, to date, no such suit has been filed. Moreover, the theories which the states would be asserting are not at all obvious. It is likely that the argument could be founded on a

theory of a violation of states' rights.

It is unclear how this combination of creative tax legislation and potential judicial review will play out over the next several years. Nonetheless, if the limitation of the SALT deduction has proven one thing, it is that there may be no tax legislation that clever tax attorneys cannot work around. Stay tuned.

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