Tax Cuts and Jobs Act Update

States Respond to the Federal, State, and Local Tax Deduction Limitation

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One of the changes made by the Tax Cuts and Jobs Act (TCJA) has been to restrict the deduction of state and local taxes (SALT) to $10,000 per year. This change will have the greatest impact on individuals living in states with relatively high tax rates. In response to this, many states have been exploring different responses to this change in order to allow taxpayers who pay more than $10,000 to continue to fully deduct those taxes and avoid a tax increase.

The primary response being discussed involves creating an alternative contribution to a state charitable fund in order to preserve the tax deduction as a charitable contribution. In addition, some states have discussed creating a payroll tax deduction to preserve the tax deduction as a payroll tax. Furthermore, some states intend to sue the federal government for penalizing high-tax states.

A charitable contribution in lieu of taxes

Several states are looking at this option, with California leading the way. (California has a high personal income tax rate.) This would involve a state-created charity that performs a government function, and contributions would provide state income tax credits equal to the charitable contribution. California introduced legislation (S.B. 227) in early January to allow residents to make voluntary contributions to a new California Excellence Fund and to then claim a state tax credit equal to 85% of the amount contributed. The contribution to the fund would presumably be deemed a federal charitable contribution, allowing taxpayers to claim a federal charitable deduction in lieu of a state income tax deduction. In April of this year, a new proposal was introduced that would allow taxpayers to purchase state tax credits by making contributions to California nonprofit organizations, school districts, community colleges, and colleges and universities.

New Jersey authorized the creation of a charitable fund for property tax credit purposes. New Jersey Governor Murphy signed a bill (S. 1893) on May 4, 2018, that would permit municipalities, counties, or school districts to establish charitable funds and allow donors to receive property tax credits of up to 90% of their New Jersey property tax liability in exchange for donations.

New York's bill (S. 7509), discussed below and signed on April 18, 2018, also permits localities to create charitable funds that would benefit their communities and would provide property owners a credit of up to 85% of contributions to such funds against applicable property taxes.

Another similar proposal is making its way through the Illinois legislature (H.B. 4237). This bill would also create an income tax credit equal to taxpayer contributions to a new state "Education Excellence Fund" to pay for public projects. In addition, the bill would allow a property tax credit for dollars contributed to a county treasury in lieu of property taxes. As of the writing of this article, the Illinois Senate has not passed the bill yet due to some concerns that school districts may be unable to collect tax dollars designated as "charitable contributions."

On May 31, 2018, Connecticut Governor Dannel Malloy signed into law new legislation (Public Act No. 18-49) that permits a municipality within the state to provide a residential property tax credit for the following tax year. However, this tax credit would include qualifiers.

The credit cannot exceed the lesser of:
• The amount of property tax owed
• 85% of the amount of voluntary, unrestricted, and irrevocable cash donations made by or on behalf of the owner of a residential property located in the municipality to a “community supporting organization” during the calendar year preceding the year in which an application for a tax credit is filed. This effectively permits a taxpayer to redirect amounts that otherwise would have been classified as property taxes, which are subject to the $10,000 federal SALT cap, as charitable donations, which are not subject to such cap.

Will these workarounds actually work for federal tax purposes? The argument is that some states already offer tax credits for charitable funds with the blessing of the Internal Revenue Service (IRS) and that these programs are no different. If these are found to be against the intent of the IRS, then those already existing tax credit programs for charitable funds would have also have to be revisited.

The IRS has responded by issuing Notice 2018-54 on May 23, 2018, that informed taxpayers that federal law controls the characterization of the payments for federal income tax purposes regardless of the payments under state law. The US Department of Treasury intends to issue proposed regulations addressing the deductibility of state and local tax payments for federal income tax purposes. It appears that the notice was issued to dissuade taxpayers from making donations to state charitable contribution funds.

The basic obstacle with this charitable contribution approach is that in order for a charitable contribution to be deductible, there must be a genuine charitable aspect. The contributor cannot primarily benefit or involve a quid pro quo, meaning that if one actually receives a credit against state tax liability, then they actually benefit from a reduced tax liability from that state entity. Also, while governmental entities are qualifying organizations for purposes of claiming the charitable deduction under Internal Revenue Code §170, contributions are deductible if the contribution is “solely for public purposes.”

The IRS would probably take substance over form. Meaning that if it looks and acts like a tax, then the IRS and the Courts would probably say it is a tax, no matter what form it tries to take.

Swapping payroll taxes for income taxes

Another approach states are considering is to swap individual income tax liability with tax-deductible employer-side payroll taxes. New York has taken the lead at an expanded payroll tax deduction for employers. Governor Cuomo signed a bill (S. 7509) on April 12, 2018, that created a 5% payroll tax and created two charitable funds to offset the deduction limit. The basics of this approach include an employer paying an increased payroll tax on wages earned above $40,000 per employee, which would be deductible by the employer for U.S. federal income tax purposes, and on the employee side, the employee would receive a state tax wage credit that would offset the employee’s state personal income tax liability (in essence, this compensates employees for the decline in their take-home pay resulting from the new payroll tax).

Again, this approach also has its share of legal hurdles and practical employer/employee issues to overcome. It is possible that this approach may not pass muster with the IRS.

Filing suit against the federal government

The governors of New York, New Jersey, Connecticut, and Maryland have joined forces and filed a lawsuit against the federal government claiming the SALT limitation as being a discriminatory act by Congress (New York v. Mnuchin, No. 18-cv-6427 (S.D.N.Y. 7/17/18) (complaint for declaratory and injunctive relief)). According to the Tax Foundation, these states have the highest combined state and local tax burdens. The lawsuit alleges that the SALT cap violates the Tenth and

Sixteenth Amendments to the Constitution, as well as provisions that prohibit Congress from exerting undue influence to coerce states to adopt policies preferred by the federal government. Some critics say the case has no chance of passing legal muster and that it is more of a political move than a legal one. Others think that high tax states should spend their time and resources examining their own state tax systems and how to make them fairer in light of the federal changes.

Conclusion

The tax treatment of these types of programs is far from being clear. Whether the payments to these charitable funds or the additional employer payroll tax will actually be deductible for US federal income tax purposes remains uncertain. As mentioned above, the IRS has cast some doubt on these so-called workarounds. For those in high-taxpaying states, monitor your state legislation and the IRS for updates and seek the advice of a tax professional regarding their implications for federal tax purposes before proceeding with making any such payments.

For more information, contact your Key Private Bank Advisor.

About the Author

As a senior financial planner with Key Private Bank, Tina Myers offers her clients sophisticated financial planning advice and a comprehensive set of strategies to grow and preserve their wealth. She collaborates with her team's Relationship and Portfolio Managers, coordinates strategies with attorneys and accountants, and follows up on a regular basis to ensure the plan is performing optimally.