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# State Strategies to Preserve SALT Deductions for High-Income Taxpayers: Will They Work?

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## Key Findings

- Several states are exploring strategies to preserve the full state and local tax deduction for high-income residents, which is capped at $10,000 under the new tax law.
- In California, legislation has been filed to allow residents to make contributions in lieu of taxes, making a voluntary contribution to a new California Excellence Fund and then claiming the full amount as a credit against state income tax liability, since the state and local tax deduction is capped but the charitable deduction is not.
- In New York, Governor Andrew Cuomo is considering creating a new employer-side payroll tax with a commensurate credit against state income tax liability, since employer-side payroll taxes are deductible.
- Case law and IRS regulations generally require charitable intent for a contribution to be deductible, meaning that the individual does not receive a substantial benefit from the contribution. Against this requirement, the sole purpose of the proposed contributions in lieu of taxes proposal is financial gain.
- While the availability of state tax credits does not disallow taking the federal charitable deduction for genuine charitable contributions, any such contribution to a governmental entity must be "solely for public purposes."
- It is quite possible that the IRS would consider a new employer-side payroll tax with a fully compensatory tax credit to constitute payment of an employee's income taxes by the employer, which would not only negate the benefit of the plan but could actually increase taxpayer liability.
- Although proponents have contemplated the possibility of graduated-rate payroll taxes to replace graduated-rate income taxes, they have yet to address how such a system would handle individuals with multiple income streams.

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- The practical challenges of a payroll tax swap are daunting as well, and the proposal rests on the highly suspect assumption that wages would adjust downward to keep both employer and employee whole.

- Both proposals are interesting, but unlikely to succeed for both legal and practical reasons. If states are genuinely concerned about the effects of their tax codes absent an uncapped state and local tax deduction, they should consider revisiting their tax rates rather than devising increasingly convoluted and legally suspect workarounds.

# Introduction

Although the recently enacted federal tax law will reduce income tax liability for the overwhelming majority of taxpayers,[1] some states are chafing at the new $10,000 cap on the state and local tax (SALT) deduction. The uncapped deduction dampened the impact of high state and local tax burdens and resulted in the subsidization of these jurisdictions' higher expenditures.[2] Initially the speculation of academics and practitioners, methods of "gaming" (or "fixing") the new tax code to reduce federal tax liability for high-income earners are now being openly considered by elected officials in states like New York and California.[3] But can they work?

Following a mad dash to allow prepayment of property taxes in the final days of 2017—a strategy that only worked in a few select jurisdictions—the two main approaches that have emerged as possibilities are (1) allowing individuals to make contributions in lieu of taxes to the state treasury or a specific state fund to enable taking the full amount under the charitable deduction; and (2) swapping individual income tax liability with tax-deductible employer-side payroll taxes. Both are intriguing ideas, but they raise serious legal and practical challenges, and as noted by *The New York Times* editorial board, can have unintended consequences.[4]

That has not stopped states from considering them. California Senate Leader Kevin de León (D) has introduced legislation on the contributions in lieu of taxes strategy,[5] while New York Governor Andrew Cuomo (D) is hinting at pursuing the payroll tax approach.[6]

1 See Tax Foundation, "Preliminary Details and Analysis of the Tax Cuts and Jobs Act," Dec. 18, 2017, https://taxfoundation.org/final-tax-cuts-and-jobs-act-details-analysis/, finding increases in after-tax income for all income groups; Amir El-Sibaie, "Who Gets a Tax Cut Under the Tax Cuts and Jobs Act?" Tax Foundation, Dec. 19, 2017, https://taxfoundation.org/final-tax-cuts-and-jobs-act-taxpayer-impacts/, calculating liability for sample taxpayers; and Tax Policy Center, "Distributional Analysis of the Conference Agreement for the Tax Cuts and Jobs Act," Dec. 18, 2017, http://www.taxpolicycenter.org/publications/distributional-analysis-conference-agreement-tax-cuts-and-jobs-act/full, finding that 80.4 percent of taxpayers receive a tax cut and only 4.8 percent experience a tax increase in 2018.

2 See generally, Jared Walczak, "The State and Local Tax Deduction: A Primer," Tax Foundation, March 15, 2017, https://taxfoundation.org/state-and-local-tax-deduction-primer/.

3 Ben Casselman, "Democrats in High-Tax States Plot to Blunt Impact of New Tax Law," *The New York Times*, Dec. 31, 2017, https://www.nytimes.com/2017/12/31/business/high-tax-states-law.html; Dylan Matthews, "This One Weird Trick Lets Blue States Avoid Trump's Tax Hike," *Vox*, Dec. 28, 2017, https://www.vox.com/policy-and-politics/2017/12/28/16818680/state-local-tax-deduction-income-payroll-trump-tax-reform-republican.

4 *The New York Times* Editorial Board, "Can States Fix the G.O.P. Tax Law?" Jan. 3, 2018, https://www.nytimes.com/2018/01/03/opinion/states-fix-gop-tax.html.

5 Katy Murphy, "California's Proposed Federal Tax Cap Work-Around, Unveiled," *The* (San Jose, Calif.) *Mercury News*, Jan. 4., 2018, https://www.mercurynews.com/2018/01/04/californias-proposed-federal-tax-cap-work-around-unveiled/.

6 Gov. Andrew Cuomo, "2018 State of the State Book," State of New York, https://www.governor.ny.gov/sites/governor.ny.gov/files/atoms/files/2018-stateofthestatebook.pdf, 148.

States have not sought to maximize the size of high earners' state and local tax deductions in the past. If that had been the only goal, then states would have repealed their sales taxes in favor of sole reliance on higher income taxes after 1986, when federal law removed the deduction of sales taxes, or after 2004, when the deduction was changed to allow claiming one or the other, but not both.[7] The main reason is that states pursue other goals with their tax policy besides maximizing take-home pay for those with large income tax liabilities, like revenue adequacy, progressivity, growth, economic development, and competitiveness.

Perhaps this time is different. States pursuing such tax dodging strategies, however, face significant obstacles. To be deductible, charitable contributions must have a genuinely charitable aspect, and cannot primarily benefit the contributor or involve a *quid pro quo*. Payments which function as taxes may be classified as taxes even if states choose to call them something else. The viability of a payroll tax approach depends in large part on the complete absence of wage stickiness, and if paired with a graduated-rate income tax, may be unimplementable. These ideas, however creative, have dim prospects of success.

### *What is the State and Local Tax Deduction?*

The state and local tax (SALT) deduction permits taxpayers who itemize deductions on their federal income tax to deduct certain taxes paid to state and local governments from their gross income for federal income tax liability purposes. Taxpayers may deduct their property taxes plus either their state income or sales taxes, but not both.

Under the newly implemented tax law, the deduction is now capped at $10,000 per year. A significantly higher standard deduction is also likely to reduce the number of filers who itemize from 30 percent to about 10 percent.

The state and local tax deduction disproportionately favors high-income taxpayers, particularly those in high-tax states. This was even more true prior to this year, under an uncapped deduction, when more than 88 percent of the benefit flowed to filers with incomes in excess of $100,000.

Six states—California, New York, New Jersey, Illinois, Texas, and Pennsylvania—have claimed more than half the value of the deduction in the past, and in New York and California, it represents 9.1 and 7.9 percent of adjusted gross income respectively, compared to a median of 4.5 percent.[8]

The deduction reduces the cost of state and local government expenditures, particularly in high-income areas, with lower-income states and regions subsidizing higher-income, higher-tax jurisdictions. A $10,000 cap, however, will limit the impact of those transfers, prompting some states to seek "fixes" to restore the full deduction for their own high-income taxpayers.

7 For a history of changes to the state and local tax deduction, see Congressional Budget Office, "The Deductibility of State and Local Taxes," Feb. 2008, https://www.cbo.gov/sites/default/files/110th-congress-2007-2008/reports/02-20-state_local_tax.pdf, 4-5.

8 Jared Walczak, "The State and Local Tax Deduction: A Primer."

## Contributions in Lieu of Taxes

Newly-introduced California legislation would allow taxpayers to make voluntary charitable contributions to a new California Excellence Fund, then take the full amount as a credit against state tax liability. The goal is to enable taxpayers who take itemized deductions on their federal tax returns to claim the full amount of their state tax payments under the charitable deduction, rather than being limited to the $10,000 available under the revised state and local tax deduction.

The approach is clever, but even the most charitable interpretations of federal statutes, case law, administrative rulings, and IRS guidance suggest that these efforts will face serious headwinds.

### Restrictions on the Charitable Deduction

First, while governmental entities are qualifying organizations for purposes of claiming the charitable deduction, expressly delineated at IRC § 170, contributions are only deductible if, per IRS guidance, the contribution "is solely for public purposes (for example, a gift to reduce the public debt or maintain a public park)."[9] The requirement that charitable contributions have a charitable aspect is a significant challenge for this approach.

Internal Revenue Service Publication 526 outlines what qualifies as a deductible charitable contribution, specifically excluding contributions from which one benefits, to the extent of that benefit. For instance, if one purchases a $250 ticket to a benefit dinner, and the fair market value of the dinner is $50, then $200 can be deducted—not $250.[10] Arguably, the benefit of, say, a $20,000 "contribution" to one's state which yields a $20,000 credit against state tax liability is, in fact, $20,000, completely wiping out deductibility. The contributor actually receives two benefits: one, the benefit of government services, and two, the benefit of a reduction in overall tax liability.

The contribution is also not "solely for public purposes," as it transparently serves no public purpose (it has no net effect on state revenue) and is intended to leave the giver in better shape financially. This is not an incidental outcome; it represents the intended purpose of the strategy, and it flies in the face of what the IRS considers a charitable contribution.

Second, the Internal Revenue Code stipulates that if, as the result of a charitable contribution, a liability is assumed by the recipient, the deductible value of the charitable contribution is reduced by the amount of that liability.[11] Even if we ignore the benefit to the taxpayer, which itself likely rules out claiming the deduction, the liability undertaken by the state (in the form of being required to provide a dollar-for-dollar tax credit) could very well provide the basis for disallowing the deduction.

Third, several court cases create significant bars to the strategy. In *United States v. American Bar Endowment*, the U.S. Supreme Court held that when a charitable contribution has a dual character, "a taxpayer must at a minimum demonstrate that he purposely contributed money or property in

9 U.S. Department of the Treasury, Internal Revenue Service, "IRS Pub. 526, Charitable Contributions," 2016, https://www.irs.gov/publications/p526.
10 Id.
11 IRC § 170(f)5.

excess of the value of any benefit he received in return" for any portion of the contribution to be deductible.[12] In *Singer Co. v. United States*, the U.S. Court of Claims ruled that a payment of money generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return[13]—and certainly, a net tax savings would appear to constitute a net benefit.

In *Hernandez v. Commissioner*, the Supreme Court, reiterating a distinction between "unrequited payments to qualified recipients, which are deductible, and payments made to such recipients with some expectation of a quid pro quo in terms of goods or services, which are not deductible," went so far as to say that even religious benefits could count as a *quid pro quo*.[14] Where, then, would that leave a contribution made solely for financial gain?

There is even a question of whether the arrangement would be regarded as a charitable contribution in the first place. *American Bar Endowment*, *Singer Co.*, and *Hernandez* all give reason to doubt that the contribution would qualify for the deduction given the lack of charitable intent, but federal rules and jurisprudence suggest the possibility that the IRS might simply regard a charitable contribution to state government, offset by a credit against state tax liability, as being nothing more than a tax payment by another name. Public statements by the proponents of the strategy essentially admitting that as the goal would be instructive for an IRS action to disallow it.

In defining personal property taxes, IRS regulations note that "[a] tax may be considered to be imposed in respect of personal property even if in form it is imposed on the exercise of a privilege."[15] Andy Grewal, professor of law at the University of Iowa, highlights the Fifth Circuit's ruling in *Campbell v. Davenport*, which propounds the rule more generally: "whether a particular contribution or charge is to be regarded as a tax depends upon its real nature."[16] If it looks like a tax and acts like a tax, the IRS and the courts could very well say that it simply *is* a tax.

## Current Treatment of Charitable Tax Credits

The best counterargument, which has been advanced by Kirk Stark, a law professor at the UCLA School of Law, is the existence of a range of existing state tax credits for contributions to certain nongovernmental entities, like neighborhood assistance programs or education scholarship organizations.[17] Under prior federal tax law, this was largely irrelevant for federal tax liability, since both state and local taxes were deductible in full. These credits could only reduce federal tax liability for filers subject to the alternative minimum tax (AMT), which disallows the state and local tax deduction but retains the charitable deduction.

A key distinction is that these contributions are not made to the state but to private charities. They do reduce state tax liability, often quite significantly, but they do so by leaving the state treasury

12 *United States v. Amer. Bar Endowment*, 477 U.S. 105 (1986).

13 *The Singer Company v. the United States*, 449 F.2d 413 (Ct. Cl. 1971).

14 *Hernandez v. Commissioner*, 490 U.S. 680 (1989).

15 Treas. Reg. § 1.164-3.

16 Andy Grewal, "Can States Game the Republican Tax Bill with the Charitable Contribution Strategy?" *Notice & Comment* blog (*Yale Journal on Regulation*), Jan. 3, 2018, http://yalejreg.com/nc/can-states-game-the-republican-tax-bill-with-the-charitable-contribution-strategy/.

17 Ben Casselman, "Democrats in High-Tax States Plot to Blunt Impact of New Tax Law."

worse off rather than making it whole. The contributions in lieu of taxes proposal is completely different. It is not a doubling of benefits for charitable contributions at a cost to the state treasury, but rather a benefit to the state that incurs a corresponding liability.

Furthermore, while contributions to genuine charitable organizations, like food banks, free clinics, and scholarship organizations, could conceivably yield a benefit for select taxpayers subject to the alternative minimum tax, the contribution also benefits a party other than the donor, while the proposed contributions in lieu of taxes are structured exclusively for the benefit of the taxpayer.

It is possible that the IRS has been unduly lax in its treatment of these types of existing tax-advantaged contributions, but even if not, the proposal under consideration in high-tax states at present is distinguishable from what is currently permitted. Contributions to private nonprofits, however tax-advantaged, are substantively different than contributions to states which are subsequently reflected in full in state tax liability.

Stark, with coauthor Phillip Blackman, previously observed that state tax credits received for charitable contributions are generally viewed as a reduction in liability as opposed to a deemed tax payment,[18] which is potentially significant in determining whether to treat the transfer as a charitable contribution (which may still be disallowed) or a veiled tax payment, but remains far from definitive.

A 2010 IRS memorandum considered whether, if a state provided a tax credit for contributions to either a state agency or a nonprofit charitable organization (at the taxpayer's discretion), those contributions could be deducted for federal tax purposes. The memo, which is nonprecedential and does not constitute published guidance, concludes that they can, but with conditions that the contributions in lieu of taxes proposal could not meet.[19]

First, the scenario considered in the memo involved a credit for contributions to a range of both state and non-state entities, instead of only permitting the credit for payments to a state entity. Allowing a 100 percent credit for charitable contributions to a state agency of one's choice *or* to a private charity might be consistent with the provisional findings of the 2010 memo, but it is highly doubtful whether any state would be willing to risk taxpayers being able to earmark their tax dollars, either to their favored government programs or to private charities.

Second, the memo itself considers the issue unresolved, observing that the office had analyzed similar issues twice before without resolution and with the suggestion that the issue "could be addressed in official public guidance." The memo notes that "[a]t this time, published guidance on the issue is not contemplated."[20]

Third, the memo stipulates that "[a] transfer is not made with charitable intent if the transferor expects a direct or indirect return benefit commensurate with the amount of the transfer," and summarizes *Singer* to the effect that "[i]f the benefits expected to be received by a donor are

18 Phillip Blackman and Kirk Stark, "Capturing Federal Dollars with State Charitable Tax Credits," *Tax Notes*, April 1, 2013, http://sd24.senate.ca.gov/sites/sd24.senate.ca.gov/files/Capturing%20Federal%20Dollars%20with%20State%20Charitable%20Tax%20Credits%20%28April%202013%29.pdf.

19 IRS CCA 201105010, Oct. 27, 2010 (released Feb. 4, 2011), https://www.irs.gov/pub/irs-wd/1105010.pdf.

20 Id., 4.

substantial (that is, greater than those incidental benefits that inure to the general public from transfers for charitable purposes), then the transferor has received a quid pro quo sufficient to remove the transfer from the realm of deductibility."[21] In this case, because the benefit of the state tax credit (which serves to lower overall tax liability) and the provision of government services are substantially larger than the benefits of giving to charity, the IRS would likely consider the contribution not to be made with charitable intent.

Fourth, while the memo tentatively concludes that the expected state tax benefit under consideration did not run afoul of these limitations due to the general rule that the benefit of deductions (typically not *credits*) does not negate charitable intent, it also posits that "there may be unusual circumstances in which it would be appropriate to recharacterize a payment of cash or property that was, in form, a charitable contribution as, in substance, a satisfaction of tax liability."[22] The contributions in lieu of taxes proposal is precisely such a circumstance.

## Swapping Payroll Taxes for Income Taxes

Another proposal comes from Daniel Hemel, an assistant professor of law at the University of Chicago. He proposes that states shift some of their revenue generation away from individual income taxes into employer-side payroll taxes, since the latter continue to be deductible.[23] Professor Hemel explains how this might work:

> The easiest way to implement this would be through an employer-side payroll tax and an offsetting employee-side wage credit (which would be fully refundable). In Illinois, where the state income tax rate is a flat 4.95%, that would mean imposing a payroll tax on Illinois employers of 5.208% x wages and allowing individuals to claim a credit of 4.95% x wages earned in Illinois. Thus, if my employer previously paid me $100, it could instead pay me $95.05, then pay 5.208% x $95.05 = $4.95 to the state, and its out-of-pocket costs would remain the same ($95.05 + $4.95 = $100.00). My gross income for federal and state income tax purposes would be $95.05, and my state wage credit (4.95% x $95.05) would perfectly offset my state income tax liability (4.95% x $95.05). (The refundable credit should be made available to nonresidents who earn wages in Illinois—e.g., commuters from northwest Indiana to Chicago—so as to avoid potential Dormant Commerce Clause objections.)[24]

It might be objected that if this is the "easy" way, one would prefer not to see the hard way. In truth, however, it does get harder if states impose a graduated-rate income tax. In these states, Hemel proposes either selecting a rate roughly equal to the effective state income tax rate for median-income households or to attempt the creation of a graduated-rate payroll tax.

21 Id.

22 Id.

23 Daniel Hemel, "Repeal of the SALT Deduction for Income Taxes Might Not Raise a Cent," *Medium*, Nov. 9, 2017, https://medium.com/whatever-source-derived/repeal-of-the-salt-deduction-for-income-taxes-might-not-raise-a-cent-7fb44eb590fb. Professor Hemel's article offers several other critiques of, and questions about, the tax reform legislation that are no longer pertinent due to subsequent revisions to the bill, but his core argument is unaffected by those revisions.

24 Daniel Hemel, "Implementing a State-Level Payroll Tax in Response to the Rollback of SALT," *Medium*, Dec. 28, 2017, https://medium.com/whatever-source-derived/implementing-a-state-level-payroll-tax-in-response-to-the-rollback-of-salt-9ca712e30cf3.

## Legal Hurdles for a Payroll Tax Swap

Legally, this proposal—or at least a simplified variant of it—might be on somewhat firmer footing than contributions in lieu of taxes. Certainly there is nothing to prevent states from shifting to employer-side payroll taxes, and it is undeniably true that such tax payments are deductible. The credit, however, poses potential legal issues. The IRS might well conclude that this is little more than a shell game, with the employer effectively remitting the employee's income tax payments on his or her behalf. A progressive payroll tax, a concept that does not currently exist and is inconsistent with present notions of what a payroll tax is, would be particularly likely to draw IRS scrutiny.

Because the payroll tax only applies to wage income, moreover, leaving nonwage income like interest, dividends, and capital gains ineligible for the benefit, it may run afoul of the constitutions of states like Illinois, Massachusetts, and Pennsylvania, where courts have strictly interpreted uniformity clauses.

Graduated-rate taxes pose an additional wrinkle for those who draw income from more than one employer. Under an income tax, individuals are taxed according to their income in aggregate, so multiple employers remitting payroll taxes across a progressive rate schedule would not correspond with the employee's actual tax liability. Proponents of this approach have yet to suggest how this might be resolved.

Writing at *Vox*, Dylan Matthews optimistically contends that "[t]he plan could run into some speed bumps, but they're likely surmountable," yet he concedes that this particular hurdle "could be an administrative nightmare" and "might be surmountable, but would require careful drafting of the law and regulation by tax collectors." How this could be done in a way that would not meet with IRS resistance is left unaddressed.[25]

It is a little-known fact that it is legal (if rare) for a company to pay an employee's income taxes. But if the payments were determined to be for income rather than employer-side payroll taxes, no one would get the benefit of a deduction. In fact, the arrangement could substantially increase the taxpayer's liability. In *Old Colony Trust Co. v. Commissioner*, the Supreme Court ruled that any amount that a third party spends paying someone's tax liability is itself taxable income.[26] If that amount is paid by the third party, it too is taxable, *ad infinitum*. The problem can be solved using a geometric progression formula, but under the proposal, after employer and employee were theoretically made whole, the employee would in fact face a new tax bill.[27]

25 Dylan Matthews, "This One Weird Trick Lets Blue States Avoid Trump's Tax Hike."

26 *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929).

27 For a general explanation of the principle, see Daniel Engber, "Can Someone Else Pay Your Taxes?" *Slate*, Jan. 23, 2006, http://www.slate.com/articles/news_and_politics/explainer/2006/01/can_someone_else_pay_your_taxes.html.

## Practical Challenges to a Payroll Tax Swap

Even if legal concerns are dispensed with, for the proposal to work, employers must either reduce salaries or accept a substantial increase in employment costs. While Hemel imagines companies cutting salaries in correspondence with the amount of their newly acquired payroll tax liability, in practice wages tend to be sticky. Many employees, either unaware that the swap may work to their benefit or sensing an opportunity for a salary increase, may resist a pay reduction. A large percentage, moreover, may be under contract or have their compensation tied to the prevailing wage, the minimum wage, labor agreements, or other conditions which make a salary reduction—even an ostensibly beneficial one—difficult or impossible.

If a state somehow succeeded with this strategy (and New York may well try), the effect would be much larger than simply to restore an uncapped state and local tax deduction for federal itemizers. It would also provide the benefit of a state tax deduction to filers who take the standard deduction, allowing them to benefit both from one of the largest itemized deductions and the newly increased standard deduction. It would not, however, apply to interest, dividend, and capital gains income—only wage income.

In offering his proposal, Hemel tries to answer why states have not pursued this strategy in the past, given that it would have conferred certain advantages (lower FICA taxes, avoidance of the AMT and Pease limitation, and—quite significantly—the exclusion of state taxes for filers who take the standard deduction), concluding that "[w]hile it's a bit of a mystery, the best explanation is probably that the benefits aren't yet enough to motivate states to rearrange their tax system."[28] A better explanation would be that states prefer income taxes because they raise more revenue, capture nonwage income, enable progressive rate structures, and properly handle filers with multiple sources of income.

If the possible legal battles are insufficient to dissuade states from acting, the political challenges probably will be. Creating a significant new tax, and expecting little political resistance to a plan under which some employees take a substantial pay cut while others are held harmless (without the former receiving a greater tax benefit), and some businesses maintain their current labor costs while others see them skyrocket, would require the expenditure of a tremendous amount of political capital, to say nothing of the economic consequences. This proposal, with its assumptions about salaries seamlessly adjusting and individual taxpayers understanding and accepting the changes, is probably destined to remain an academic exercise, not a political reality.

28 Daniel Hemel, "Repeal of the SALT Deduction for Income Taxes Might Not Raise a Cent."

# Conclusion

The scramble to restore the uncapped state and local tax deduction in high-tax states is in some ways a curious political exercise, as it largely involves elected officials who have championed progressive taxation contemplating intricate, almost Rube Goldbergesque ways to make the federal tax code less progressive for wealthy taxpayers in their states. The proposals are inventive and in many respects quite interesting, but for both legal and practical reasons, they are unlikely to succeed.

If high-tax states are genuinely concerned that, absent federal subsidization of their tax rates, they might see outmigration or changes in taxpayer behavior, it would be more productive to revisit state tax rates than devising increasingly convoluted ways to enable high-income earners to reduce their federal tax liability.