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California's SALT Deduction Cap Workaround Is Legally Dubious and Needlessly Regressive

Written Testimony for the California Assembly Committee on Revenue and Taxation on SB 227

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Chairwoman Burke and Members of the Committee:

Senate Bill 227 has gone through multiple iterations since its introduction, but from the initial language to the substitute before you, the bill's basic intention has remained constant: to provide a credit against state income tax liability for contributions to government-linked funds, with the intent of allowing high-income taxpayers to recharacterize their tax payments as charitable contributions to reduce tax liability under the new federal tax law.

The federal Tax Cuts and Jobs Act caps the state and local tax deduction at $10,000 as part of the offset for rate reductions. Senate Bill 227 is designed to allow taxpayers to retain the effect of the uncapped deduction by reclassifying tax payments as charitable contributions. There are two primary objections to this approach: first, that it is legally dubious and could leave taxpayers worse off; and second, that it is a regressive policy which doubles down on tax reductions for some of the highest-income earners in the country.

Let me take those in reverse order.

Our analysis at the Tax Foundation agrees with that of groups across the ideological spectrum, groups like the Tax Policy Center and the Institute on Taxation and Economic Policy: under the new federal law, most California taxpayers will see a tax cut, and often a significant one. This is true for low- and high-income taxpayers alike, and it's true in every single congressional district in the state.

Taxpayers with incomes above $200,000 would be the primary beneficiaries of this proposed workaround to the state and local tax deduction cap. We looked at how they fare under federal tax reform in every congressional district in the country (https://tax.foundation/2tD54iL). In California, this class of taxpayers sees its after-tax income rise by 4.1 percent on average.

It's important to understand what this means. Imagine, for simplicity's sake, that you had $200,000 in taxable income and paid $40,000 in federal taxes, for an effective tax rate of 20 percent and an after-tax income of $160,000. A 4.1 percentage point increase in after-tax income for this taxpayer represents a tax cut of $6,560—a reduction in tax liability of more than 16 percent!

The distribution of these tax reductions varies, of course. The smallest benefit is in California's 14th Congressional District, centered in San Mateo County, where after-tax income increases by just under 2.5 percent. For someone facing an effective tax rate of 20 percent before federal reform, that's a 10 percent tax cut. If the effective rate were higher, the reduction would be as well. The median California congressional district sees a 4.5 percent increase in after-tax income for filers with income of $200,000 or more.

These taxpayers, therefore, are already getting a good deal under the new federal tax law. So do those whose incomes aren't as high, it's important to add, but the focus here is on higher-income taxpayers, because they're the ones who stand to benefit from SB 227. Given that most of these taxpayers are already receiving a substantial net tax cut, allowing them the benefit of the rate reductions *and* attempting to restore an uncapped deduction is curious from a policy standpoint.

It is also legally suspect. Amendments to SB 227 may have been intended to cure certain defects and improve the legislation's chances of surviving legal scrutiny, but ultimately, they are likely to prove little more than window dressing. In its current form, the offsetting tax credit is not one-to-one, meaning that the taxpayer's liability to state and local government actually increases for those taking advantage of the credit program, but this does little to render the program genuinely charitable in nature, since its primary – arguably, from the taxpayer's standpoint, *only* – purpose is to decrease overall tax liability. A payment intended to improve the payor's financial standing is not a charitable gift, and the Internal Revenue Service is not going to regard it as one.

Under SB 227, taxpayers can elect to write a check to the Local Schools and Colleges Voluntary Contributions Fund in lieu of ordinary tax payments, but semantics aside, there is no doubt that this payment is made in satisfaction of tax liability, and that most of the contribution (85 percent of it) is offset by the recipient in the form of a corresponding credit against California individual income tax liability.

We are still awaiting formal IRS guidance, but the IRS has issued a notice indicating where it is headed, specifically referencing the principle of substance over form—that the IRS cares about the purpose and effect of the payment, not what it is called or what form it takes. If a payment is made in satisfaction of tax liability, it's probably a tax payment, even if technically the recipient was a "voluntary contributions fund."

It has always been the case that taxpayers could only claim a deduction for charitable contributions above and beyond the value of any benefit received. If you buy a $250 ticket to a benefit dinner, and the dinner itself has a market value of $50, then only $200 (not $250) is eligible for the deduction. Under existing law, regulations, and case law, the most generous interpretation would be that an 85 percent credit allows the taxpayer to take the remaining 15 percent as a deduction for federal tax purposes. And that math doesn't add up.

Imagine a taxpayer with $50,000 in state tax liability. (We'll assume that they've used up the $10,000 state and local tax deduction on local property taxes and want to convert the full state amount into charitable contributions.) If they contributed $58,824 to the Local Schools and Colleges Voluntary Contributions Fund, they would receive a $50,000 credit, wiping out their state tax liability. They've increased their state tax (and tax-like) payments by nearly $9,000, but if they face the top marginal rate of 37 percent at the federal level, they'll cut their federal tax liability by $21,765, for a net savings of $12,941.

If, however, they can only claim the residual 15 percent of that contribution at the federal level, then their federal tax savings are only $3,2645, for a net tax *increase* of $5,559 after taking the higher payments to California into account. Californians who took the state up on this proposal could face a serious tax hike.

Proponents have argued that the existence of charitable tax credits for purposes ranging from free clinics to mental health services to education scholarships provides a foundation for state and local tax deduction workarounds. Lawmakers should be wary of this theory.

Designed when the state and local tax deduction was uncapped, these existing programs were not designed as, and rarely functioned as, a workaround. (They incidentally offered an additional tax benefit to AMT filers.) The lack of IRS interest in these programs when their use as a tax avoidance strategy was modest should not be interpreted as a grant of permission for taxpayers to engage in aggressive tax avoidance tactics using contributions which lack donative intent. It is, moreover, possible – even likely – that existing programs will see greater scrutiny now that their use actually changes federal tax liability, and it would not be surprising for the federal benefit to be limited to the portion of the contribution not offset by a state tax credit.

These existing programs would, presumably, still exist and enjoy considerable popularity. A taxpayer who cares about a particular charitable cause may be quite happy to claim, say, a state credit for 50 percent of the contribution, and a federal deduction for the remaining 50 percent (but not the full amount), which make her cost less than $32 for every $100 received by the charity. That's a pretty good deal. But if the overriding goal is to recharacterize payments to reduce tax liability, then whether the credit certification is at 50 percent, 85 percent, or 100 percent, the strategy is highly unlikely to work.

We have explored the legal challenges at greater length, in our own white papers (see, e.g., http://tax.foundation/2DrX0Z1) and in a symposium on the topic hosted by the *Columbia Journal of Tax Law* (https://tax.foundation/2Iu52yW), among other venues. States adopting the contributions in lieu of taxes approach are not only pursuing a doubtful strategy, but one that could leave taxpayers facing *greater* tax liability.

The IRS has broad latitude in defining eligible charitable contributions, and ample legal basis for doing so. To avoid steering California taxpayers wrong or dealing with angry filers who overpaid to the state without receiving their expected federal windfall, it would probably be prudent to shelve tax recharacterization plans pending the issuance of IRS guidance on the subject.

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