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Salt Deduction Limitation: Can Highly-Taxed States Dodge the Bullet?

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I. Introduction:

Tax policy is no stranger to political platforms, and the 2016 presidential election was no different. During his campaign, President Donald Trump promised, among other things, that he would introduce a complete overhaul to the American tax system, resulting in tax relief to all classes of Americans and large corporations.¹ Like many before him, Trump's lofty economic goals were to be accomplished via sweeping changes to the federal tax code.

Promises of tax reform have not often translated into legislative action; aside from President George W. Bush lowering taxes with the Economic Growth and Tax Relief Reconciliation Act of 2001², there has not been a major federal tax reform since 1986.³ But that all changed on December 22, 2017, when President Trump signed the Tax Cuts and Job Act ("TCJA").⁴ This Act delivered on Trump's promise of a sweeping overhaul of the American federal tax system. The changes were broad and controversial in many aspects, none more so than the provisions put into place regarding the State and Local Tax (SALT) deduction. Specifically, whereas the Internal Revenue Code (IRC) previously allowed taxpayers to deduct *all* of their state and local tax payments from their taxable income (with certain limited exceptions), the TCJA capped the deduction at \$10,000.⁵ This SALT deduction limitation only affects individuals that itemize their deductions, as opposed to taking the standard deduction,

¹ Howard Gleckman, *The Final Tax Bill Falls Far Short of President Trump's Campaign Promises*, FORBES, (Dec. 18, 2017).

² Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001)

³ Daniel McDonald, *Are State Responses to the Tax Cuts and Jobs Act Worth Their Salt?*, TAX NOTES: STATE TAX NOTES, (Feb. 25, 2019), <https://www.taxnotes.com/state-tax-notes/tax-cuts-and-jobs-act/are-state-responses-tax-cuts-and-jobs-act-worth-their-salt/2019/02/25/29448>

⁴ Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054, (2017).

⁵ Scott Ahroni, et al., *Congress and the SALT deduction Past, Present, and Future*, THE CPA JOURNAL, (Jan. 2018) <https://www.cpajournal.com/2018/01/22/congress-salt-deduction/>

and does not apply to businesses.⁶ In 2017, roughly 465 million filers itemized deductions, but the Joint Committee on Taxation estimates that the number of filers who itemize will fall to only 21 million by 2024 because of the cap.⁷

The SALT deduction has been around in various forms since the American Civil War,⁸ and it has been characterized by some as “the most generous tax break for millions of Americans.”⁹ But the deduction itself has undergone important changes at various moments in time. For example, it was only until 1978 that individuals were able to deduct taxes paid on motor fuels.¹⁰ In addition, the deduction for general sales tax was repealed in 1986, only to be reinstated again in 2004.¹¹ But these changes pale in comparison to the much more significant reforms introduced by the TCJA.¹² The previously allowed full deduction of SALT taxes was eliminated with the TCJA, and replaced with a cap of \$10,000 per individual.¹³

Historically, the SALT deduction has been one of the largest indirect federal subsidies provided to states, and is estimated to have cost the federal government roughly \$527 billion for the years of 2015-2019.¹⁴ Proponents of the unlimited SALT deduction note that this federal expenditure allows states to levy higher taxes on their own citizens and thus provide more valuable services as a result. These services typically come in the form of infrastructure,

⁶ I.R.C. § 162 (Dec. 22, 2017).

⁷ STAFF OF J. COMM. ON TAXATION, 115TH CONG., Tables Related to the Federal Tax System (Apr. 24, 2018), <https://www.jct.gov/publications.html?func=startdown&id=5093>.

⁸ *History of the U.S. Tax System*, U.S. DEP. OF THE TREAS; FACT SHEETS: TAXES, (Aug. 23, 2013), <http://archive.li/x386G>.

⁹ *Congress and the SALT deduction*, *supra* note 5.

¹⁰ Frank Sammartino, *Repeal of the State and Local Tax Deduction*, TAX POLICY CENTER, (Mar. 7, 2017), <https://www.taxpolicycenter.org/publications/repeal-state-and-local-tax-deduction/full>.

¹¹ *Repeal of the State and Local Tax Deduction*, *supra* note 10.

¹² Margolin, Winer & Evans LLP, *irs issues proposed guidance on controversial salt limitation*, (Oct. 2, 2018), <https://www.mwellp.com/news/2018/10/irs-issues-proposed-guidance-on-controversial-salt-limitation/>.

¹³ *Are State Responses to the Tax Cuts*, *supra* note 3.

¹⁴ *Repeal of the State and Local Tax Deduction*, *supra* note 10.

education, health, and public welfare, which benefits society as a whole.¹⁵ On the other hand, many argue that limiting the SALT deduction would increase revenue at the federal level, which could potentially result in more direct subsidies paid to the states.¹⁶ More importantly, however, is the revenue-generating aspect of the limitation. The TCJA will “reduce individual income taxes on average for all income groups and in all states,” and lower corporate taxes, meaning forgone federal revenue.¹⁷ These severe tax cuts need to be compensated for within other areas of the tax code, which is why the limitation was put into effect. To put this into perspective, if the limitation were repealed, the treasury would lose roughly \$600 billion over the next ten years.¹⁸ The TCJA is essentially paying for a large portion of the reduction in taxes with the SALT deduction limitation, but this burden is not necessarily being shouldered fairly among the states.

In response, several states have taken legislative action to reduce the effects of the SALT deduction cap, and this paper will discuss three of the most prevalent strategies that have been discussed thus far. First is the charitable contribution workaround, which essentially attempts to re-label SALT taxes as charitable contributions, which are still fully deductible federally.¹⁹ Next, states could rely more heavily on payroll taxes, paid by the employer, as opposed to income taxes, which are paid by the individual employee.²⁰ These payroll taxes, which are paid

¹⁵ *Repeal of the State and Local Tax Deduction*, *supra* note 10.

¹⁶ *Repeal of the State and Local Tax Deduction*, *supra* note 10.

¹⁷ Frank Sammartino, et al., *The Effect of the TCJA Individual Income Tax Provisions Across Income Groups and Across the States*, TAX POLICY CENTER, (Mar. 28, 2018). <https://www.taxpolicycenter.org/publications/effect-tcja-individual-income-tax-provisions-across-income-groups-and-across-states/full>.

¹⁸ Kyle Pomerleau, *Eliminating the SALT Deduction Cap Would Reduce Federal Revenue and Make the Tax Code Less Progressive*, TAX FOUNDATION, (Jan. 4, 2019). <https://taxfoundation.org/salt-deduction-analysis/>

¹⁹ *Are State Responses to the Tax Cuts*, *supra* note 3.

²⁰ *Are State Responses to the Tax Cuts*, *supra* note 3.

to the state, are still fully deductible, whereas income taxes are subject to the SALT cap.²¹ Lastly, some states have changed the taxation of pass-through entities.²² Typically, the individual owners of the pass-through entities paid taxes on the earnings of the entity; hence the taxes “passed through” the entity to the individual.²³ After the TCJA, however, some states have enacted legislation that would shift state taxes to the entity level, which would be fully deductible.²⁴ These three strategies have one thing in common; they all attempt to transform SALT taxes, which are subject to the \$10,000 limit, into fully deductible payments made to the state.

II. The Disproportionate Effect on High-Tax States

One of the most controversial aspects of the SALT deduction cap is its disproportionately adverse effects on high-tax and largely Democratic states. Individuals in states with high taxes have taken advantage of the SALT deduction to a greater extent than have individuals in low tax states. For example, individuals in New Jersey, California, and New York accounted for over 25% of all individuals in the United States who took the SALT deduction in 2015,²⁵ totaling roughly \$200 billion in total deductions claimed by individuals in only three states.²⁶ Additionally, the average SALT deductions in New York and California were \$22,169 and \$18,438, respectively.²⁷ On the other end of the spectrum were low tax states like Alaska,

²¹ *Are State Responses to the Tax Cuts*, *supra* note 3.

²² Timothy P. Noonan, *Recent Passthrough entity Tax Credits and Other SALT Workarounds*, HODGSON RUSSELL ATTORNEYS LLP; NOONAN’S NOTES BLOG (Jan. 7, 2019), <https://www.hodgsonruss.com/blogs-Noonans-Notes-Blog, recent-passthrough-entity-tax-credits-and-other>.

²³ Adam Hayes, *Flow-Through Entity*, INVESTOPEDIA; TAXES, (Apr. 9 2019), <https://www.investopedia.com/terms/f/flow-through.asp>.

²⁴ *Recent Passthrough entity Tax Credits*, *supra* note 21.

²⁵ *Congress and the SALT deduction*, *supra* note 5.

²⁶ *Congress and the SALT deduction*, *supra* note 5.

²⁷ *Congress and the SALT deduction*, *supra* note 5.

where the average SALT deduction was \$4,800 in 2014, less than half the current limitation.²⁸ Leaders of high-tax states, such as New York's Governor Cuomo, fear that the heightened tax bill of its citizens will cause wealthy individuals to flee to lower tax states.²⁹ If this were to hold true, the state's overall tax revenues would likely decline.³⁰ In early February, state officials for New York announced that the state is facing a roughly \$2.3 billion drop in revenues as a result of the SALT deduction cap.³¹ Similarly, Connecticut expects that the SALT limitation will result in over \$10 billion in lost SALT deductions in 2018, resulting in an increase to Connecticut taxpayer's federal income tax by roughly \$3 billion.³²

High-tax states have not taken lightly to the pronounced effect that the new SALT deduction limitation has had on them, when compared to states with lower taxes. Shortly after the TCJA was enacted, New York announced it had formed a coalition to sue the federal government and challenge the TCJA, along with Connecticut and New Jersey.³³ Since then, five other states have agreed to work with the coalition in an effort to repeal the SALT deduction cap by arguing against its constitutionality in the courts. Their main arguments center around the claim that the SALT deduction cap was not solely economically motivated, and was

²⁸ Chuck Devore, *New York and Other High-Tax States Sue Over SALT Deduction Cap While Jobs Follow Lower Taxes*, FORBES, (Jul. 26, 2018), <https://www.forbes.com/sites/chuckdevore/2018/07/26/new-york-and-other-high-tax-states-sue-over-salt-deduction-cap-while-jobs-follow-lower-taxes/#5693a426346b>.

²⁹ Jesse McKinley, et al., *Wall Street's Slide Hurts New York; City Loses Nearly \$1 Billion in Tax Revenue*, NEW YORK TIMES, (Feb. 7, 2019), <https://www.nytimes.com/2019/02/07/nyregion/nyc-revenue-taxes-budget.html>.

³⁰ *Wall Street's Slide Hurts New York*, supra note 29.

³¹ Paige Jones, *Report: Donations to New York SALT Workaround Funds Likely to Drop*, TAX NOTES: STATE TAX TODAY, (Mar. 1, 2019), <https://www.taxnotes.com/state-tax-today/charitable-giving/report-donations-new-york-salt-workaround-funds-likely-drop/2019/02/28/2962v?highlight=charitable%20contribution>.

³² Ct. State Dept. of Rev., *CT Joins Lawsuit to Protect Taxpayers on Salt Deduction Cut*, Connecticut's Official State Website, (Jul. 17, 2018), <https://portal.ct.gov/DRS/News---Press-Releases/2018/CT-Joins-Lawsuit-to-Protect-Taxpayers-on-SALT-Deduction-Cut>.

³³ Governor's Press Office, *Governor Cuomo Announces New York, New Jersey, and Connecticut Launch Coalition to Sue the Federal Government Over Federal Tax Bill*, (Jan. 26, 2018), <https://www.governor.ny.gov/news/governor-cuomo-announces-new-york-new-jersey-and-connecticut-launch-coalition-sue-federal>.

intended to be nothing more than a political bullet fired at Democratic states who had not supported Trump’s candidacy.³⁴ This paper, however, will focus solely on state’s attempts to circumvent the SALT deduction limitation.

III. How States Are Responding to the SALT Deduction Cap

While the battle over the constitutionality of the TCJA ensues, high-tax states are trying to find ways to mitigate the effects of the SALT deduction cap.³⁵ These strategies largely entail taking payments that would otherwise take the form of SALT taxes and converting them into some other form of payment obligation that would remain fully deductible under the IRC. Specifically, states have attempted to create SALT cap “workarounds,” in the form of charitable contributions, payroll taxes, and changes to the taxation of pass-through entities.³⁶

A. The Charitable Contribution Method

The first and most common workaround strategy involves the allowance of charitable donations to the state in lieu of taxes paid. Section 170 of the IRC, left untouched by the TCJA, allows taxpayers to deduct their charitable contributions, and the deduction is not subject to any cap.³⁷ These deductions are made “below the line” meaning they are deducted from a taxpayer’s adjusted gross income for purposes of determining the taxpayer’s taxable income, and can only be taken by taxpayers who itemize their deductions.³⁸ Thus, Section 170 might

³⁴ Michael C. Dorf, *The New Tax Law Punishes Blue States: Is That Constitutional?* VERDICT: JUSTIA, (Dec. 27, 2017), <https://verdict.justia.com/2017/12/27/new-tax-law-punishes-blue-states-constitutional>.

³⁵ Amandeep S. Grewal, *The Charitable Contribution Strategy: An Ineffective SALT Substitute*, 38 VA. TAX REV. 203, 205 (2018).

³⁶ *Are State Responses to the Tax Cuts, supra note 3.*

³⁷ 26 I.R.C. §170 (Aug. 13, 2018).

³⁸ Selena Maranjian, *Your Taxes, Above and Below the Line*, The Motley Fool, (Mar. 1, 2007). <https://www.fool.com/taxes/2007/03/01/your-taxes-above-and-below-the-line.aspx>.

potentially facilitate circumvention of the SALT cap; rather than pay “taxes” to the state, which would be deductible only up to \$10,000, the taxpayer might instead make “charitable contributions” to the state, which would be deductible to an unlimited amount.

To accomplish the workaround, a state would have to create state-operated charitable funds that would use any payments received for public purposes.³⁹ Next, the state would have to enact legislation that would permit the taxpayer to claim a credit for the charitable contribution that offsets state tax liability.⁴⁰ The taxpayer could then make what would be the functional equivalent of a tax payment to the state, while at the same time claiming an uncapped deduction for the payment as a “charitable contribution” when calculating taxable income under the IRC. Indeed, such a scheme could end up lessening the taxpayer’s overall tax liability even if states ended up affording only a partial credit for the “contributions” to their designated charitable funds.

Consider, for instance, New York’s recently-created charitable contribution system, which reflects an early attempt to work around the SALT deduction cap.⁴¹ Recent legislation signed by Governor Cuomo created two charitable contribution funds, one devoted to healthcare and the other devoted to education. Under the new law, as one commentator has described it, “[d]onors will receive a state tax credit of up to 85 percent of their contributions [to these funds], partially circumventing the \$10,000 SALT deduction cap.”⁴² At first glance, this may seem illogical for a taxpayer, who would only be getting an 85% credit. However, if a

³⁹ *The Charitable Contribution Strategy*, *supra* note 35.

⁴⁰ *The Charitable Contribution Strategy*, *supra* note 35.

⁴¹ Paige Jones, *New York Governor Signs Nation’s First SALT Workaround Law*, TAXNOTES: STATE TAX TODAY, (Apr. 18, 2018), <https://www.taxnotes.com/state-tax-today/budgets/new-york-governor-signs-nations-first-salt-workaround-law/2018/04/18/27zb2>.

⁴² *New York Governor Signs*, *supra* note 41.

taxpayer is in the highest tax bracket of 37%, even an 85% credit would substantially mitigate the effects of the SALT deduction cap.

New Jersey enacted similar legislation which authorizes localities to establish charitable funds to be used as a revenue source, allowing for up to a 90% credit towards the taxpayer's property taxes.⁴³ Illinois has even proposed a 100% credit for payments to the state's "Excellence Fund," which is to be used strictly for public purposes.⁴⁴ However, the bill has been stalled by the House after being approved by the Senate, and may be in its "death knell."⁴⁵ Many other states, including Oregon, California, and Connecticut, have introduced similar legislation, albeit not for a full 100% credit.⁴⁶

Suppose, for example, that a New York resident owes state and local taxes of \$500,000. Currently under the TCJA, the taxpayer would only be allowed to deduct \$10,000 of the \$500,000 from his federal tax liability. The additional \$490,000 would still be taxable federally, and assuming that the income is subject to a 37% tax rate, would amount to taxes of \$181,300. The charitable contribution workaround would offer a more advantageous tax scenario for the same taxpayer. If instead of paying the \$500,000 state and local taxes, the taxpayer were to make a \$500,000 donation to the charitable contribution fund, he would be given a \$425,000 (or 85%) credit against his state and local tax obligations, leaving him with an extra \$75,000 of income taxable by the state. However, the taxpayer would then be able to deduct the initial \$500,000 contribution when calculating his federal income taxes. A deduction of \$500,000 at a

⁴³ *Are State Responses to the Tax Cuts, supra note 3.*

⁴⁴ ILLINOIS INCOME TAX ACT H.B. 4237, 100TH GEN. ASSEMB., REG. SESS. (Ill. 2019).

⁴⁵ Ernst Hunter, *Tax Reform Friday: SALT Cap Deduction Workarounds on Collision Course with Proposed Treasury Regs*, BLOOMBERG: SALT TALK BLOG, (Aug. 24, 2018), <https://www.bna.com/tax-reform-friday-b73014481996/>.

⁴⁶ Christy Bieber, *Will State SALT Cap Workarounds Help You Deduct More of Your State and Local Taxes?*, CREDIT KARMA, (Apr. 17, 2019), <https://www.creditkarma.com/tax/i/salt-cap-workaround/>.

tax rate of 37% is \$185,000, which clearly provides tremendous savings for the taxpayer, considering that without the donation a deduction of only \$10,000 would be allowed. Again, this hypothetical system only provides an 85% tax credit, meaning that a larger credit could produce even greater savings for the taxpayer, but is certainly not necessary in order to encourage a taxpayer to take advantage of the charitable contribution workaround. Also, as represented by the table, the individual would still be allowed to take the \$10,000 SALT deduction even with the charitable contribution, which would bring the taxpayer's total federal deduction to \$510,000.

Table 1

\$500,000 State and Local Tax liability (At 37% Federal Tax Bracket)	Without Charitable Contribution Workaround	With Charitable Contribution Workaround
Charitable Contribution	\$0	\$500,000
Credit Given	\$0	\$425,000
Federal Deduction Allowed	\$10,000	\$510,000
State Taxes Paid	\$500,000	\$75,000
Amount Taxable Federally	\$490,000	\$0
Federal Taxes Paid	\$181,300 (\$490,000 x 37%)	\$0
Value of Federal Deduction	\$3,700 (\$10,000 x 37%)	\$188,700 (510,000 x 37%)

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Note, however, that the value of the federal deduction for the taxpayer with a charitable contribution is partially offset by the fact that the taxpayer still has to pay \$75,000 in SALT taxes. Still, the value of the federal deduction (\$188,700) more than outweighs the SALT

⁴⁷ Americo LaSalvia, J.D. Candidate, 2019, Seton University School of Law.

payment, and is drastically greater than the value of the federal deduction without the charitable workaround in place.

Attractive as it might be, this workaround carries only limited promise, thanks to its dubious legality. Indeed, in August of 2018, the Internal Revenue Service (“IRS”) issued a proposed rule that would render the tactic unavailable to those seeking to avoid the SALT cap. The proposed rule would require taxpayers to reduce their federal charitable contribution deduction by the amount of credit that the individual receives from their state for such contribution.⁴⁸ In other words, a taxpayer would only be able to federally deduct the amount of the contribution that was not credited towards the taxpayer’s state and local tax liability. This means that if a taxpayer makes the before mentioned \$500,000 charitable contribution and receives an 85% credit against SALT tax liability, only the remaining 15% for which the taxpayer receives nothing in return for would be viewed as a true charitable contribution under Section 170. This reduction would completely eliminate any incentive for a taxpayer to utilize the state-operated charitable fund. Although this proposed regulation curtails the possible future benefits of the workaround, the proposed rule would be in effect for any payments made after August 27, 2018, leading many to believe that charitable contributions made before that date would be eligible for the workaround.⁴⁹

Taxpayers, however, must tread lightly because “regulations are often retroactively effective to the enactment date of the code section they relate to,” meaning there is always the

⁴⁸ *Contributions in Exchange for State or Local Tax Credits*, 83 FED. REG. 43563 (Aug. 27, 2018).

⁴⁹ Paul Jones, *Tax Pros Cast Jaundiced Eye on SALT Cap Workarounds*, TAXNOTES: STATE TAX NOTES, (Feb. 18, 2019), <https://www.taxnotes.com/state-tax-notes/tax-cuts-and-jobs-act/tax-pros-cast-jaundiced-eye-salt-cap-workarounds/2019/02/18/294lc?highlight=Connecticut%20charitable%20contribution>.

possibility that the rule would be effective as of the date of the enactment of the TCJA.⁵⁰ Still, one expert commented, “if they were going to do that, they would have said [the rules are effective] from the date of the enactment [of the TCJA].”⁵¹ Still, many professionals in the tax field are advising their clients to steer clear of relying on charitable contributions for their 2018 tax returns, which would make previously existing charitable programs the unintended victims to this proposed rule.⁵² “I think we’re going to see a drop in charitable donations across the board for everything for a number of reasons,” one expert opined, adding that “The public will get a sense of . . . these restrictions.”⁵³ Even if the proposed rule does not take effect until August, there looms the possibility that the IRS would need to audit the return just to confirm the date that the charitable contribution was made, which would allow them to scrutinize every aspect of the tax return.⁵⁴

In support of the proposed rule, the IRS relied heavily on the Supreme Court’s definition of what entails a Section 170 charitable contribution.⁵⁵ The Code defines a charitable contribution as a gift that “is made for exclusively public purposes,”⁵⁶ and the Supreme Court in United States v. American Bar Endowment held that the “sine qua non of a charitable contribution is a transfer of money or property without adequate consideration.”⁵⁷ This means that if the alleged charitable contribution is made with the expectation that some type of consideration will be given, it is not deductible under Section 170. In other words, “a payment

⁵⁰ *Tax Pros Cast Jaundiced Eye*, *supra* note 49.

⁵¹ *Tax Pros Cast Jaundiced Eye*, *supra* note 49.

⁵² *Tax Pros Cast Jaundiced Eye*, *supra* note 49.

⁵³ *Tax Pros Cast Jaundiced Eye*, *supra* note 49.

⁵⁴ *Tax Pros Cast Jaundiced Eye*, *supra* note 49.

⁵⁵ *Contributions in Exchange*, *supra* note 48.

⁵⁶ *Contributions in Exchange*, *supra* note 48.

⁵⁷ See *United States v. American Bar Endowment*, 477 U.S. 105, 116-118 (1986).

of money cannot constitute a charitable contribution if the contributor expects a substantial benefit in return.”⁵⁸ Thus, as illustrated by the example above, the “substantial benefit” expected from the charitable contribution workaround would be the offsetting credit against SALT taxes, and that substantial benefit—given from the state to the taxpayer—would preclude the contribution from counting as “charitable.” Thus, where an 85% tax credit is given, the taxpayer would only be able to deduct 15% of their contribution, which represents the portion of the contribution which was not given in expectation of the tax credit.

The proposed regulation has received over 7,700 comments to date.⁵⁹ Among them is the jointly-authored response of the Attorneys General of New Jersey, California, Connecticut and New York, which state:

The proposed rules would undermine state sovereignty by depriving state and local governments of the revenue necessary to sustain vital public services...In addition, the proposed regulations would upset the status quo for the individuals, charities, and governments that have come to depend on existing programs.⁶⁰

In all likelihood, this argument will be found unpersuasive. At the end of the day, these high-tax states control their own fate when it comes to the SALT cap’s effect on their citizens; if they wish to minimize the effect, they may need to revisit their own taxation strategies and find a way to lower state taxes. Additionally, the “status quo” is not really upset by the proposed rule, as the deductibility of legitimate charitable contributions is unaffected.

⁵⁸ *Id.* at 116.

⁵⁹ *Contributions in Exchange*, *supra* note 48. (Showing Number of Comments Received).

⁶⁰ Letter from the Attorneys General of N.J., Cal., Ct., and N.Y., to Charles P. Rettig, Comm. of the I.R.S. (Oct. 11, 2018), https://ag.ny.gov/sites/default/files/irs_reg-112176-18_comment_of_nj_ca_ct_ny_ags.pdf.

Unfortunately, anxious taxpayers negatively affected by the SALT deduction limitation can only hold their breath as the IRS deliberates and hope that the charitable contribution workaround will provide at least some tax relief.

B. Employer Payroll Tax

Another federal tax provision that was left untouched by the TCJA is the deduction for payroll taxes paid by employers. This provision creates another opportunity for states to convert SALT payments, subject to the SALT cap, into payments that are fully deductible at the federal level. Specifically, Section 162 of the IRC allows a deduction for “all the ordinary and necessary expenses” that a company pays during its tax year.⁶¹ Payroll taxes—which are paid to the state—fall under this category⁶², while income taxes paid individually by the employee obviously do not, meaning states could “soften the blow” of the SALT deduction cap by relying more heavily on payroll taxes as sources of revenue.⁶³ In order for this strategy to work, a state would reduce or eliminate its income tax and instead implement a payroll tax that the employer, rather than the employee, would pay.⁶⁴ Employees would still feel the incidence of this tax in the form of reduced wages and salaries, but they would ultimately see less of a revenue loss on account of the full deductibility of the payroll tax itself.⁶⁵

Consider, for instance, the following scenario.⁶⁶ A state replaces a 4.95% income tax with a 5.208% employer-based payroll tax.⁶⁷ Individuals earning \$1 million per year would

⁶¹ § 162, *supra* note 6.

⁶² 26 I.R.C. § 164 (Dec. 22, 2017).

⁶³ Daniel Hermel, *State Payroll tax Shift Stands on Solid Legal Ground*, MEDIUM, (Jan. 5, 2018), <https://medium.com/whatever-source-derived/state-payroll-tax-shift-stands-on-solid-legal-ground-fe769d8ab309>.

⁶⁴ *State Payroll tax Shift Stands*, *supra* note 63.

⁶⁵ *State Payroll tax Shift Stands*, *supra* note 63.

⁶⁶ *State Payroll tax Shift Stands*, *supra* note 63.

⁶⁷ *State Payroll tax Shift Stands*, *supra* note 63.

likely see their wages decrease by approximately 4.95% or \$49,500, leaving them with a \$950,500 salary instead.⁶⁸ The employer would then pay the payroll tax of 5.208% on the \$950,500 salary, which also equals roughly \$49,500.⁶⁹ The employer would end up paying out a total of \$1 million either way, but the employee would see his or her taxable income drop by \$49,500.⁷⁰ In a 37% federal tax bracket, the individual would save over \$18,000 in federal taxes.⁷¹

Table 2

	With 5.208% Payroll Tax	With 4.95% Income Tax
Wages/salary:	\$950,500	\$1,000,000
Employer Pays:	\$49,500	\$0
Employee Pays	\$0	\$49,500
Federal Tax Liability	\$950,500 x 37% = \$350,685	\$990,000 x 37% = \$366,300
Tax Advantage	\$15,615 (366,300-350,685)	

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In addition to pursuing the charitable contribution workaround, New York has also passed legislation that pursues this payroll tax strategy. Under the New York system, called the Employer Compensation Expense Program, the state's income tax is not eliminated.⁷³ But employees would receive a tax credit that offsets their income tax liability, based on the amount that the employer has paid in payroll taxes.⁷⁴ In this system, employers could

⁶⁸ *State Payroll tax Shift Stands*, *supra* note 63.

⁶⁹ Daniel Hermel, *State Payroll tax Shift Stands on Solid Legal Ground*, MEDIUM, (Jan. 5, 2018), <https://medium.com/whatever-source-derived/state-payroll-tax-shift-stands-on-solid-legal-ground-fe769d8ab309>.

⁷⁰ *State Payroll tax Shift Stands*, *supra* note 69.

⁷¹ *State Payroll tax Shift Stands*, *supra* note 69..

⁷² Americo LaSalvia, J.D. Candidate, 2019, Seton University School of Law. (Using Daniel Hermel's example).

⁷³ *Employer Compensation Expense Program (ECEP)*, N.Y. DEPT. OF TAXATION AND FINANCE, (Apr. 2, 2019).

⁷⁴ *Employer Compensation Expense Program*, *supra* note 73.

voluntarily opt-in to the payroll tax and pay an additional 5% tax to the state on wages paid to employees earning \$40,000 or more.⁷⁵ The effect is the same as above, where the employer would likely reduce the employee's wages to compensate for the new tax burden, but the employee would have a lower federal income tax bill because of their reduced wages. More importantly, the employer would be able to deduct the 5% paid as a payroll tax from its federal tax liability as a necessary business expense, still fully deductible under Section 162.⁷⁶

Therefore, the individual would have a reduced taxable income (and thus a reduced federal income tax obligation), and the employer would end up in largely the same financial position. Despite the reduction in income, the taxpayer will still be in a better financial position, thanks to lower tax obligations and the credit against state income taxes.

Like the charitable contribution tactic, there always looms the possibility that the IRS will challenge the payroll tax strategy. As of yet, the IRS has not issued any proposed regulations on the topic. However, tax professionals have highlighted some potential issues that the IRS could raise.⁷⁷ The main issue would be the possibility that the payroll-substitution system would run afoul of the third-party payor rule laid out in *Old Colony Trust Co. v. Commissioner*,⁷⁸ where the Supreme Court held that a third-party paying another's tax is to be considered taxable income to the non-payor. In other words, there is a chance that the IRS could view the employer payroll tax as if the employer was essentially paying the employee's income tax on their behalf. If the IRS successfully prohibits the payroll method via the third-

⁷⁵ *Employer Compensation Expense Program*, *supra* note 73.

⁷⁶ § 162, *supra* note 6.

⁷⁷ *State Payroll tax Shift Stands*, *supra* note 69.

⁷⁸ *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 718 (1929).

party payor argument, all of the tax paid by the employer would qualify as taxable income to the employee. In the example above, the \$49,500 that the employer pays in payroll tax and subtracts from the taxpayer's income would be added back to the taxpayer's income for purposes of calculating federal tax obligations, and any benefit of the shift to payroll tax would be lost.

There are, however, arguments against the third-party payor scenario.⁷⁹ For one thing, the *Old Colony Trust* case dealt with a taxpayer who was having a third party directly pay his taxes, whereas the payroll tax strategy would involve a tax credit provided to the taxpayer for whatever the employer paid on his behalf. In *Randall v. Loftsgaarden*, the Supreme Court stated that "the 'receipt' of tax deductions or credits is not itself a taxable event."⁸⁰ Therefore, using Supreme Court precedent, it would be unlikely that the IRS would succeed on a claim that the tax credit to the taxpayer is a taxable ascension to wealth. Additionally, considering that seven states currently have no income tax, it would be difficult for the IRS to argue that a state's decision to tax payroll rather than income can be viewed as a taxable event to the employee.⁸¹

Even if the IRS allows the payroll tax as a strategy to circumvent some of the effects of the SALT deduction cap, the strategy does not come without its flaws. The main issue with the strategy would be the administrative burden it would place on tax collectors and employers.⁸² First, some individuals draw income from multiple employers, and under a traditional income

⁷⁹ *State Payroll tax Shift Stands*, *supra* note 69.

⁸⁰ *Randall v. Loftsgaarden*, 478 U.S. 647, 657 (1986).

⁸¹ *State Payroll tax Shift Stands*, *supra* note 69.

⁸² Jared Walczak, *State Strategies to Preserve SALT Deductions for High-Income Taxpayers: Will they Work?*, TAX FOUNDATION, (Jan. 5, 2018), <https://taxfoundation.org/state-strategies-preserve-state-and-local-tax-deduction/>.

tax, would be taxed on the aggregate value of all income. However, with a payroll tax, “multiple employers remitting payroll taxes across a progressive rate schedule would not correspond with the employee’s actual tax liability,”⁸³ and could lead to potential revenue loss to the state. Next, the assumption that individuals would be willing to forgo salary in order for the employer to remit the payroll tax may be a lofty proposition.

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.⁸⁴

The only answer to this problem would be for the employer to accept a “substantial increase in employment costs” by keeping salaries the same, while also paying the payroll tax, which seems equally unlikely.⁸⁵ Another issue is the fact that the SALT deduction cap only affects those who itemize their deductions, which amounts to about 30% of taxpayers.⁸⁶ Although this number is higher in high-tax states,⁸⁷ it still shows that there will be a substantial portion of employees who will not benefit from the switch to payroll tax, meaning it could be difficult to gather the necessary support for the implementation of the payroll tax. Furthermore, although in-state employees who itemize will benefit from the system, there is no guarantee that employees who live out-of-state will be given the corresponding tax credit by their home state.⁸⁸ Then

⁸³ *State Strategies to Preserve*, supra note 82.

⁸⁴ *State Strategies to Preserve*, supra note 82.

⁸⁵ *State Strategies to Preserve*, supra note 82.

⁸⁶ Scott Greenberg, *Who Itemizes Deductions?*, TAX FOUNDATION, (Feb. 22, 2016), <https://taxfoundation.org/who-itemizes-deductions/>.

⁸⁷ *Congress and the SALT deduction*, supra note 5.

⁸⁸ Timothy P. Noonan, *Changing Residency: The Most Effective SALT Deduction Workaround*, NYSSCPA, (Nov. 1, 2018), <http://www.nysscpa.org/most-popular-content/changing-residency-the-most-effective-salt-deduction->

again, Connecticut has enacted legislation that would allow its residents a credit for employer payroll taxes paid under the New York ECEP system. Still, Connecticut is the only state to enact such legislation.⁸⁹

Additionally, individuals with large amounts of income derived from interest, dividends, or capital gain, would be largely unaffected by a change to payroll taxes. The payroll tax would benefit only those with income in the form of wages, and nothing else.⁹⁰ Finally, states may resist the change to relying more heavily on payroll taxes because income taxes “raise more revenue, capture nonwage income, enable progressive rate structures, and properly handle filers with multiple sources of income.”⁹¹ Simply put, all the potential problems previously discussed with payroll taxes are largely non-existent with a classic income tax.

However, although there would certainly be obstacles with implementing a payroll tax, they would likely not be insurmountable. Additionally, tax professionals note that there are other inherent benefits with using a payroll system, including “the exclusion of state taxes for filers who take the standard deduction.”⁹² Still, for whatever reason, these incentives have fallen short of motivating states rearrange their tax system and incorporate a payroll tax.⁹³

C. Pass-Through Entity Tax

The third possible workaround again involves shifting taxes from the individual to business entities, similar to the shift to payroll taxes discussed in part B. As previously

workaround?fbclid=IwAR3b8d1UTJoxEyEKoBYS9kZlp4gS30k0kMLEfQLUSl6ik8qax7WOpPRbv14#sthash.Yvt0njfi.q61KxKeM.dpbs.

⁸⁹ *Changing Residency: The Most Effective*, supra note 88.

⁹⁰ *State Strategies to Preserve*, supra note 82.

⁹¹ *State Strategies to Preserve*, supra note 82.

⁹² *State Strategies to Preserve*, supra note 82.

⁹³ *State Strategies to Preserve*, supra note 82.

discussed, Section 162 of the IRC allows a deduction for “all the ordinary and necessary expenses” that a company pays during its tax year.⁹⁴ Accordingly, shifting taxes from the individual payer to an entity-level payor invites the possibility that the individual will realize tax savings, while the entity will be able to deduct taxes paid in the operation of the business at the federal level. With this in mind, several states have passed legislation that shifts taxes away from individuals and towards the entity.

1. Wisconsin

The Wisconsin legislature has passed an optional entity-level tax on the income of pass-through entities, which will partially circumvent the SALT deduction cap.⁹⁵ The owners of pass-through entities, which typically take the form of an S Corporation, limited liability company, partnership, or sole proprietorship, are traditionally taxed individually on whatever profits are paid to the owner during the tax year.⁹⁶ These type of entities are taxed only at that one level, unlike a traditional C corporation which is subject to double taxation; once at the entity level and then again at the individual level.⁹⁷ It is for that reason that these types of entities have sky-rocketed in popularity since the 1980s, while the number of traditional C corporations have dwindled during the same time span.⁹⁸ The Wisconsin bill, which was signed into law on December 14, 2018, essentially reverses the taxation of pass-through entities.⁹⁹ Under the bill, covered entities can elect to be taxed at the entity-level, rather than the individual level.¹⁰⁰ The

⁹⁴ § 162, *supra* note 6.

⁹⁵ Wis. Leg., S.B. 883, Joint Comm. on Finance (Dec. 15, 2018).

⁹⁶ Kyle Pomerleau, *An Overview of Pass-Through Businesses in the United States*, TAX FOUNDATION, (Jan. 21, 2015), <https://taxfoundation.org/overview-pass-through-businesses-united-states>.

⁹⁷ *An Overview of Pass-Through*, *supra* note 96.

⁹⁸ *An Overview of Pass-Through*, *supra* note 96.

⁹⁹ Wis. Leg., S.B. 883, *supra* note 95.

¹⁰⁰ Wis. Leg., S.B. 883, *supra* note 95.

owners of such entities will then be given an exclusion on their share of income that is distributed from the entity.¹⁰¹ An exclusion functions in a similar fashion as a deduction, having a value equal to the deduction multiplied by the individual's tax rate.¹⁰² The entity will be taxed at the state's corporate tax level of 7.9%, which will then be deductible at the state level because the \$10,000 SALT cap does not apply to corporations, only individuals.¹⁰³

2. Connecticut

Connecticut enacted similar legislation as Wisconsin, which retroactively took effect from May 31, 2017.¹⁰⁴ In Connecticut's system, only S corporations doing business in Connecticut, partnerships, and limited liability companies are required to pay a 6.99% tax on income.¹⁰⁵ The individual owners of these entities are then eligible for a tax credit, which is equal to 93.01% of the individual's share of the tax paid by the entity. Additionally, individuals will even be allowed a refund if such credit is greater than the taxes owed to the state.¹⁰⁶ Known as a refundable tax credit, if a taxpayer owes \$10,000 in tax to Connecticut but is given a credit of \$15,000, the individual will actually be paid \$5,000 by the state.

The Connecticut Legislature did not come up with a 93.01% credit out of the blue. If a full 100% credit was given, the individual would actually receive a tax windfall under the new system.¹⁰⁷ The table below illustrates how the 93.01% credit leaves the state tax liability the

¹⁰¹ Wis. Leg., S.B. 883, *supra* note 95.

¹⁰² Julia Kagan, *Income Exclusion Rule*, INVESTOPEDIA, (Mar. 22, 2018), <https://www.investopedia.com/terms/i/identified-shares.asp>.

¹⁰³ § 164 *supra* note 62.

¹⁰⁴ Connecticut Department of Revenue Services, OCG-6, Pass-Through Entity Tax (June 19, 2018).

¹⁰⁵ *Connecticut Department of Revenue Services*, *supra* note 104.

¹⁰⁶ *Connecticut Department of Revenue Services*, *supra* note 104.

¹⁰⁷ Timothy P. Noonan and Elizabeth Pascal, *The Nuts and Bolts of Connecticut's New Passthrough Entity Tax*, HODGSON RUSS ATTORNEYS LLP; NOONA'S NOTES BLOG, (nov. 12, 2018).

same as before, while offering tax savings at the federal level. For this table, assume that an S corporation generates \$5 million in revenue, and pays tax at the federal level of 37% and state level of 6.99%.

Table 3

Taxpayer	Old Connecticut System	New Connecticut System
S corporation Federal tax liability	\$0	\$0
S corporation State tax liability	\$0	\$349,500 (\$5 million x 6.99%)
Individual Federal tax liability	\$1.85 million (\$5 million x 37%)	\$1,720,685 (\$4,650,500 x 37%)
Individual state tax liability	\$349,500 (\$5 million x 6.99%)	\$325,070 (\$4,650,500 x 6.99%)
Individual tax credit	\$0	\$325,070 (\$349,500 x 93.01%)
Total taxes paid federally	\$1.85 million	\$1,720,685
Total taxes paid to state	\$349,500	\$349,500
Total taxes paid by individual	\$2,199,500	\$1,720,685

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As the table shows, shifting taxes to the entity rather than the individual would produce federal tax savings of \$129,215 (\$1.85 million - \$1,720,685). Note, however, that the drastic reduction in total taxes paid by the individual is not entirely positive. The number is reduced because the entity pays more taxes, meaning it will have less income to distribute to its owners, resulting in less recognizable income for the owner. Nonetheless, the Connecticut system will produce federal tax savings for individuals.

3. New Jersey

New Jersey has passed legislation that will allow owners of eligible pass-through entities the option to pay tax at the entity level, as opposed to individually.¹⁰⁹ Eligible entities include S corporations, partnerships, and limited liability companies.¹¹⁰ Unlike Connecticut's system,

¹⁰⁸ *The Nuts and Bolts*, supra note 107.

¹⁰⁹ S.B. 3246, 218 Leg., N.J. (2018)(Amending N.J.S.54A:4-1).

¹¹⁰ S.B. 3246, supra note 109

which imposes a flat rate of 6.99%, New Jersey would use a graduated system of tax, starting at 5.25% for entities in the lowest income threshold, and up to 10.75% for companies in the highest.¹¹¹ Similar to Wisconsin, New Jersey gives owners of these entities the option, rather than the requirement, to pay taxes at the entity level.¹¹² This is likely because these programs will only benefit entities whose shareholders are also native to the state.¹¹³ Out-of-state owners will not benefit from the pass-through election because their state may not offer the corresponding credit that is responsible for lowering the individual's federal tax burden.¹¹⁴

4. Legal and Policy Analysis

Like the charitable contribution and payroll workarounds, states must be aware of the possible legal issues associated with implementing tax changes intended to circumvent the SALT deduction cap. The IRS has yet to issue any comments or challenges regarding the taxation of pass-through entities, and many experts believe that this strategy has the most solid legal footing of any of the possible workaround strategies.¹¹⁵ One expert has commented that the IRS will likely “focus its enforcement efforts on the charitable workarounds and other low hanging fruit.”¹¹⁶ Also, in reference to the Connecticut system of pass-through entity taxation, it has been said, “It’s not at all unusual for a state or locality to impose a tax on flow-through entities. I agree. . .that it ‘works.’ I don’t think the IRS could disallow the entity the deduction

¹¹¹ S.B. 3246, supra note 109

¹¹² S.B. 3246, supra note 109

¹¹³ *The Nuts and Bolts*, supra note 107.

¹¹⁴ *The Nuts and Bolts*, supra note 107.

¹¹⁵ *Are State Responses to the Tax Cuts*, supra note 3.

¹¹⁶ *The Nuts and Bolts*, supra note 107.

just because it was designed as a workaround.”¹¹⁷ Still, the IRS is actively seeking ways to eliminate workarounds to the SALT cap, meaning there is always a possibility that they take issue with any of the strategies discussed.

Proponents of this strategy discuss the added benefits of adopting a tax at the entity level, as opposed to the individual level. In addition to partially circumventing the effects of the SALT cap, “it has the added benefit of increasing the chance that the taxes due from out-of-state owners will be paid in full, which states often find difficult to ensure.”¹¹⁸ Additionally, because “tax is collected at the entity level, often there is no need for multiple entities in a tiered partnership organization to file returns.” Therefore, taxing at the entity level would reduce compliance costs for entities with multiple tiers and owners.¹¹⁹

Legality and benefits aside, some say that this strategy “diverges sharply from the principles of sound tax policy.”¹²⁰ Scholars have noted that it is “peculiar”¹²¹ for Connecticut to give a tax break to business owners, and not wage earners, considering that business owners have already been given a “particularly lavish”¹²² tax break by the TCJA. The TCJA created section 199A of the IRC which grants owners of a “qualified trade or business” a 20% deduction for the income of the entity.¹²³ However, the IRS expressly denied the deduction to corporations and entities which are engaged in business as “a specified service trade or

¹¹⁷ Amy Hamilton, *News Analysis: Connecticut Finds a Salt Workaround That Would Actually Work*, TAXNOTES: NEWS STORIES, (Mar. 5, 2018), <https://www.taxnotes.com/tax-notes/tax-reform/news-analysis-connecticut-finds-salt-workaround-would-actually-work/2018/03/05/26xpn>.

¹¹⁸ *News Analysis: Connecticut Finds a Salt Workaround*, supra note 117.

¹¹⁹ *News Analysis: Connecticut Finds a Salt Workaround*, supra note 117.

¹²⁰ *News Analysis: Connecticut Finds a Salt Workaround*, supra note 117.

¹²¹ *News Analysis: Connecticut Finds a Salt Workaround*, supra note 117.

¹²² *News Analysis: Connecticut Finds a Salt Workaround*, supra note 117.

¹²³ 26 I.R.C. § 199A(a).

business,”¹²⁴ (SSTB) and also contains income thresholds that would prevent high income individuals from receiving the deduction.¹²⁵ After many requests for clarity as to what entails an SSTB, the IRS issued a final rule on the matter, finding that an SSTB is

a trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. The trade or business of the performance of services that consist of investing and investment management, trading, or dealing in securities.¹²⁶

Thus, owners of pass-through entities that are precluded from the deduction will certainly be thankful for the opportunity to shift taxes to the entity, despite the “peculiarity” of such a system.

IV. Conclusion

The Tax Cuts and Jobs Act shepherded in a new era of highly contested tax policy, and arguably the most disputed provision of the bill was the limitation on SALT deductions to \$10,000 per individual. In response, states with historically high taxes have sought strategies that would at least partially circumvent the effects of the limitation on their citizens. These strategies seek to take advantage of sections provided in the tax code that have been left untouched by the TCJA, such as the full deductibility of “all the ordinary and necessary” expenses paid by a trade or business, and the deductions for charitable contributions. The charitable contribution workaround was one of the earliest strategies to be utilized. In essence, this workaround transforms the payment of SALT taxes, subject to the \$10,000 limitation, into

¹²⁴ 26 I.R.C. § 199A(d)(1)(a).

¹²⁵ 26 I.R.C. § 199A(e)(2).

¹²⁶ 84 C.F.R. 2952-3014 (2019).

fully deductible payments for federal tax purposes. The taxpayer is then given a state tax credit to offset their state tax liability. However, the IRS has issued proposed rulemaking that is likely to render this strategy useless for taxpayers attempting to claim the full deduction for the charitable contribution.

Next, several states have enacted legislation that would shift income taxes, paid by the employee, to payroll taxes which are paid by the employer. This practice would again transform payments that are subject to the SALT cap, into “ordinary and necessary” expenses paid by the employer which are fully deductible. In a similar fashion, the third strategy discussed would shift taxes paid by pass-through entities away from individual owners. Once more, these taxes paid by the entity would be fully deductible.

Of the three strategies, it appears that the charitable contribution strategy is capable of producing the largest tax savings for individuals by creating large federal deductions. However, taxpayers should be certain not to take any such deductions after the date that the proposed rule is set to go into effect, or else run the risk of severely under-paying their federal tax liability. The utilization of payroll taxes, and a shift to entity-level taxation for pass-through entities would produce less tax savings than the charitable contribution method, but are less likely to be challenged by the IRS. Therefore, if states are willing to accept the administrative burdens that come with changing their tax code, they should take advantage of these workarounds.

At the end of the day, highly taxed states are deeply concerned with the SALT deduction limitation for one reason, and it's not the well-being of their citizens; it's the fact that the loss

of the complete SALT deduction will likely mean lost revenues for the state.¹²⁷ As Governor Cuomo noted, “People are mobile and they will go to a better tax situation. That is a fact.”¹²⁸ For highly taxed states like New York, there is really only one way to reverse the recent trend of people moving out of the state at a greater rate than they are moving in;¹²⁹ reduce state taxes. The only reason the SALT limitation is so burdensome to these states is because it has been so heavily relied on in the past due to their own policy of high taxation relative to other states. Therefore, it appears hypocritical for state officials of high-tax states to admonish a SALT deduction cap as an “economic missile”¹³⁰, while pushing aside the fact that this “missile” has essentially been fired by the states themselves, aimed at their own citizens.

¹²⁷ *Report: Donations to New York SALT Workaround Funds, supra note 31.*

¹²⁸ Michael Gormley, *Cuomo to Meet With Trump to Seek End of Cap on SALT Deductibility*, NEWSDAY, (Feb. 11, 2019). <https://www.newsday.com/news/region-state/salt-cuomo-trump-1.27192919>

¹²⁹ *Americans Are on the Move, but Where are They Moving To and From?*, UNITED VAN LINES: 2018 NATIONAL MOVERS STUDY (Jan. 2, 2019).

¹³⁰ *Are State Responses to the Tax Cuts, supra note 3.*