

# **Legal Uncertainty in Implementing TCJA SALT Cap**

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## TCJA: Revenue Effects of Key Provisions: 2018-27

- 21% Corporate Rate — **\$1.3 trillion**
- Lower Individual Rates — **\$1.2 trillion**
- Standard Deduction — **\$ 720 billion**
- “Pass-through” Deduction — **\$ 415 billion**
- Child Tax Credit — **\$ 573 billion**
- Limit Itemized Deductions + **\$ 668 billion**
  - *Incl. \$644 billion from \$10k limit on SALT deduction*



- **SALT deduction: 1913-2017**

*§ 164(a) – Deduction for State and Local Taxes*

Deduction for real property taxes, personal property taxes, income (or sales) taxes

*AMT — § 56(b)(1)(A)(ii) – No Deduction for State/Local Taxes (1986 on):*

NO deduction for real property taxes, personal property taxes, income (or sales) taxes

- **SALT deduction: 2018-2025**

*§ 164(b)(6) – \$10,000 Limit on Deduction for State and Local Taxes*

After 2017.... and before 2026 — SALT deduction *shall not exceed \$10,000*.

*AMT — § 56(b)(1)(A)(ii) – No Deduction for State/Local Taxes (still applies):*

NO deduction for real property taxes, personal property taxes, income (or sales) taxes

# Tax Price Effects of Nondeductibility for Top Earners in California

Pre-TCJA Effective Marginal Rate:

**8.03%**

(i.e.,  $13.3\% \times (1 - .396)$ )

Post-TCJA Effective Marginal Rate:

**13.3%**



# State Responses

- ① **Challenge Constitutionality** – NY, NJ, MD, CT
- ② **Payroll tax option** – NY  
new wage tax on employers, coupled with a reduction in employee income taxes (via credit); a corresponding reduction in gross wages
- ③ **Pass-through tax** – CT  
new entity level tax on LLCs, partnerships, coupled with a reduction in pass-through owners' income taxes (via credit)
- ④ **Charitable tax credit option** – CT, DC, IL, IN, MD, NE, NJ, OR, NY, VA, WA  
establish new charitable funds to support state/local expenditure functions – provide nonrefundable credit of X% for donations

**UNITED STATES DISTRICT COURT  
FOR THE SOUTHERN DISTRICT OF NEW YORK**

STATE OF NEW YORK,  
STATE OF CONNECTICUT,  
STATE OF MARYLAND, and STATE OF  
NEW JERSEY,

Plaintiffs,

v.

STEVEN T. MNUCHIN, in his official capacity  
as Secretary of the United States Department  
of Treasury; the UNITED STATES  
DEPARTMENT OF TREASURY; DAVID J.  
KAUTTER, in his official capacity as Acting  
Commissioner of the United States Internal  
Revenue Service; the UNITED STATES  
INTERNAL REVENUE SERVICE; and the  
UNITED STATES OF AMERICA,

Defendants.

Civil Action No. 18-cv-6427

COMPLAINT FOR DECLARATORY  
AND INJUNCTIVE RELIEF

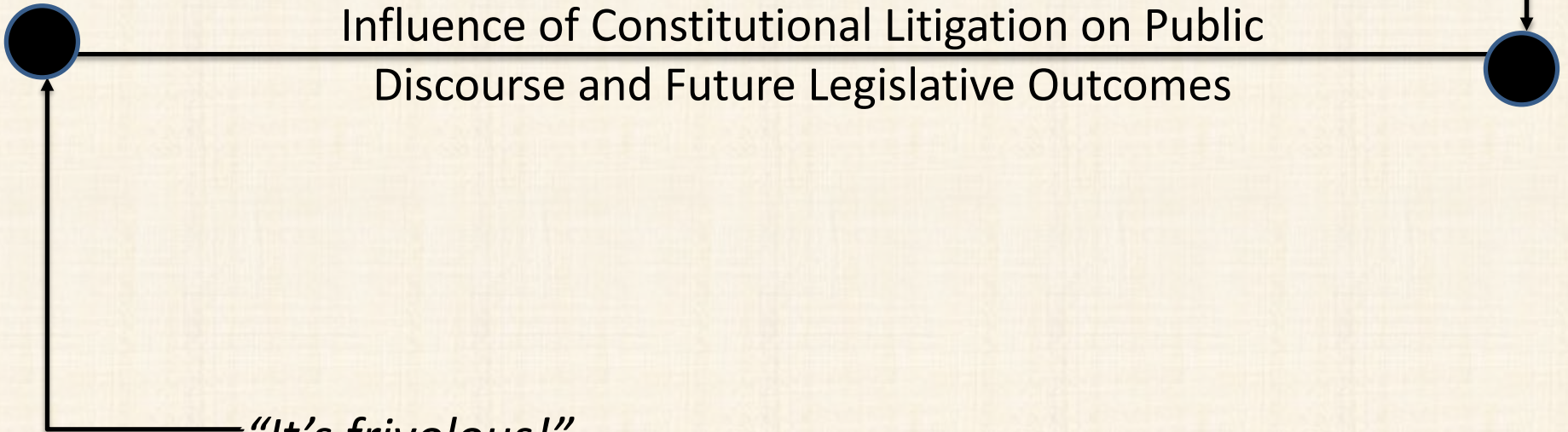
JURY REQUESTED

# *The Purpose and Function of Constitutional Adjudication*

*"It's Unconstitutional!"*

Influence of Constitutional Litigation on Public  
Discourse and Future Legislative Outcomes

*"It's frivolous!"*





# **Constitutional Dimensions of State and Local Tax Deductibility**

Daniel Patrick Moynihan  
*United States Senate*

*President Reagan's proposal to eliminate the deduction of state and local taxes for the purpose of assessing federal income taxes will vastly enlarge the scope of the federal government, unduly burden state and local governments, and greatly harm the federal system. The essence of the federal idea is that there are arenas of government that must not be invaded by other governments. Yet the Treasury Department would have us believe that the most fundamental activities of state and local governments are in some significant sense paid for by the federal government through "subsidies" provided by the federal tax code.*



# Payroll Tax/Passthrough Tax Option

- Payroll Tax Option (NY)
  - Employers opt in and pay 5% Employer Compensation Expense Tax (ECET) for employee wages over \$40,000
  - Rate of 1.5% (2019), 3% (2020), 5% (2021 on)
  - Offsetting credit to employee for amount of tax
- Passthrough Tax Option (CT)
  - New Pass-through Entity tax (PE Tax) for 2019 onward
  - Offsetting credit (PE Tax Credit) available to partners, members, shareholders (reducing nondeductible SALT)
  - Business expense deduction for PE Tax passes through to partners, members, shareholders.

# Charitable Tax Credit Option

- ***Expected Tax Liability =  $\$X$*** 
  - Taxpayer expects to owe  $\$X$  in tax for 2018.
- ***Transfer to Qualifying Entity =  $\$F$*** 
  - Taxpayer transfers  $\$F$  as a charitable contribution to some non-profit/government entity [see 26 U.S.C. §170(c)]
- ***Tax Benefit Derived from Transfer =  $\$T$*** 
  - government (federal, state, local) provides that those making such transfers are entitled to claim some tax benefit  $\$T$  [deduction/credit, a function of  $\$F$ ] in determining tax liability.
- ***Age Old Question: Deduct  $\$F$  or Deduct  $\$F - \$T$ ?***





||

?



# Age Old Answer to Age Old Question

**\$F**

***“Full Deduction Rule”***

**1917 - ?**

***The amount of a taxpayer’s charitable contribution deduction is the full amount donated, undiminished by the federal, state, or local tax benefits the taxpayer is entitled to by virtue of making the gift***



## “Full Deduction Rule” Illustrated

- Jessa expects to **owe \$90,000 in taxes** to South Carolina
- Only \$10,000 of this amount will be deductible on her federal return because of new SALT limits of §164(b)(6)
- Jessa **donates \$50,000** to the “Exceptional SC Fund” (a 501(c)(3) entity established by the state legislature to receive donations to fund tuition scholarships to private schools).
- Jessa is entitled to a **\$50,000 state tax credit**. As a result of this credit, her *actual* state income tax liability is \$40,000.

***May Jessa deduct the full \$50,000 donated to Exceptional SC on her federal return?***

## Nonrefundable Tax Credits for Exceptional SC Donations:

As of December 21, 2017 at 8:00 am:

**Donations to Exceptional SC: \$8,826,646.03**

**Available Tax Credits for Donors: Approximately \$2,173,353.97**

Anyone can donate to the Exceptional SC 501(c)(3) scholarship fund, which provides scholarships to exceptional needs students. Individuals and corporations who pay South Carolina taxes can make a donation to Exceptional SC and claim a dollar for dollar tax credit against their overall South Carolina income tax liability (personal corporate income tax). Donors can deduct contributions made to Exceptional SC on their federal income taxes under IRC Section 170.

A taxpayer may not claim more than sixty percent of his total South Carolina tax liability for the year the contribution was made. If a taxpayer deducts the amount of the contribution on his federal return and claims the nonrefundable credit, then he must add back the amount of the deduction for South Carolina income tax purposes.

### Donors are:

- Eligible to claim a dollar for dollar credit on state income tax liability;
- Not allowed to designate a specific student or school as beneficiary;
- Limited by a first come, first served annual statewide cap of \$11 million.

Please visit [ExceptionalSC.org/donate](http://ExceptionalSC.org/donate) for more information and to make a donation. **Proviso 109.11** provides that South Carolina tax credits for donations to Exceptional SC may not exceed \$11 million for Fiscal Year 2018.

“Individuals ... who pay South Carolina taxes can make a donation to Exceptional SC and claim a dollar for dollar tax credit against their overall South Carolina income tax liability... *Donors can deduct contributions made to Exceptional SC on their federal income taxes under IRS Section 170.*”

***Is this true?***



# State Charitable Tax Credits

- Very common – 115 tax credits in 33 states
- Great variety – tax credits for donations to nonprofits, government agencies, government established funds
- 2 noteworthy clusters of existing tax credits:
  - Donations of *conservation easements* (typically hover in the 50-60% range)
  - Donations to *private school voucher funds* (several states offer 100% credits)

# States with Charitable Tax Credits

<b>Alabama</b>	<b>Arizona</b>	Arkansas
California	Colorado	Delaware
<b>Georgia</b>	Hawaii	Idaho
Illinois	Indiana	Iowa
<b>Kansas</b>	Kentucky	<b>Louisiana</b>
Maryland	Massachusetts	Michigan
<b>Missouri</b>	Montana	Nebraska
New York	North Carolina	North Dakota
Oklahoma	<b>Oregon</b>	Rhode Island
<b>South Carolina</b>	Utah	Virginia
	West Virginia	



# The Federal Reaction (so far...)

- **Mnuchin:** “I think it’s one of the more *ridiculous!* comments to think you can take a real estate tax that you are required to make and dress that up as a charitable contribution.”
- **IRS:** cautious, following developments
- **Internal Revenue Service Response:**
  - May 21, 2018: Notice of New Proposed Regs
  - August 24, 2018: Proposed Regs Released
  - October 11, 2018: deadline for comments
  - November 5, 2018: Public Hearing in D.C.

# Proposed §170 SALT Credit Regs

## August 23, 2018

- Treats *all* section 170(c) entities the same
  - New blue state charitable tax credits
  - Existing blue/red state charitable tax credits (including, most importantly, voucher tax credits)
- Taxpayer must reduce amount of federal charitable contribution deduction by the value of any state or local tax credit
  - Ignore state/local tax deductions (e.g., 13.3% in CA)
  - Ignore state/local tax credits of 15% or lower
  - Ignore federal tax deduction (e.g., top rate of 37%)



# Open Questions re: Prop. Regs

- Changes during Notice/Comment?
  - Guaranteed agitation for special carve-outs
- Opportunities with 15% safe harbor?
- Open Legal questions:
  - Deduction *and* Credit? (e.g., 15% + 13.3%)
  - Transferable tax credits?
  - Recipient's Basis in Credit?
  - Is use of credit a payment of tax? (regs suggest no, but pre-TCJA law allows a “purchaser” of tax credits to treat the use of the credit as a payment of tax)
  - “Clarification” on “business-related contributions”

# IRS/Mnuchin “Clarification”

September 5, 2018

- **IRS Press Release:**

*“Business taxpayers who make business-related payments to charities or governmental entities for which taxpayers receive state or local tax credits can generally deduct the payments as business expenses.”*

- **Mnuchin quote re: school voucher programs:**

*“The proposed rule concerning the cap on state and local tax deductions has no impact on federal tax benefits for business-related donations to school choice programs.”*

- **Open Question:** would a “business-related payment” be deductible under §162 even if it generates credit against otherwise nondeductible individual state/local taxes?



## **Future SALT Cap Reform Decision Points**

- “Tax Cuts 2.0” (HR 6760 in House; Senate?)
- 2019 (post-midterms) with new Congress
- 2020 election: House, Senate, President
  - Scheduled expiration after 2025