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3 States Plan to Sue Over New Tax Law. Here's Why They Might Lose.

Connecticut, New York and New Jersey say that GOP tax policies unduly punish their populations. Some doubt whether their claims would stand up in court.

Governors from three Northeast states have announced plans to sue the federal government for discriminating against their taxing structure. But tax experts say their legal justification for doing so seems dubious at best.

The heads of state of Connecticut, New Jersey and New York have announced plans to file a joint lawsuit claiming that the federal government's new cap on deductions for state and local taxes, put in place by the Republican tax overhaul plan signed into law last month, is unjust because it targets wealthier states. Although no legal strategy has been announced, statements made by New York Gov. Andrew Cuomo suggest the lawsuit could use the U.S. Constitution's equal protection clause and the 10th Amendment protecting states' rights.

But that argument — that the law is unconstitutional because it affects different states in unequal ways — is a weak one, says Tax Foundation expert Jared Walczak.

Practically everything Washington does impacts states unevenly. For example, Florida and other states with higher retiree populations get more federal Medicare and Social Security dollars that other places. Meanwhile, the alternative minimum tax, which is designed to keep wealthy taxpayers from using loopholes to avoid paying taxes, targets a lot of residents in places like California, Connecticut and New York.

"And no one has suggested that the alternative minimum tax is unconstitutional," Walczak says. "[Cuomo's statements represent] a very novel argument and not one that is usually credited to the equal protection clause."

Capping the state and local tax deduction to $10,000 was one of the ways Congress tried to offset the cost of lowering federal income tax rates under tax reform. The cap, combined with new limits on the mortgage interest deduction, is expected to generate an additional $668 billion over the next 10 years, according to the Joint Committee on Taxation. Although Republican and Democratic lawmakers in states with higher taxes fought unsuccessfully against the cap, the policies were generally seen as disproportionately impacting more liberal-leaning states.

"It has nothing to do with sound policy," New Jersey Gov. Phil Murphy said while announcing the impending lawsuit. "It is clear: It is punishment."

But Congress has nipped and tucked the state and local tax deduction before.

When the federal income tax was first instated in 1913, all state and local taxes not directly tied to a benefit were deductible against federal taxable income. Then in 1964, Congress limited deductions to property, income, sales and motor fuel taxes. Fourteen years later, motor fuel taxes were eliminated from qualifying. And in 1986's tax reform, sales taxes were eliminated from deductibility — a move that disproportionately impacted taxpayers in states with no income tax. In 2005, Congress reinstated the sales tax deduction but only allowed taxpayers to deduct either income taxes or sales taxes (not both).

"So, over the years, Congress has apparently felt like they could narrow the deductibility," says Thomas Gais, director of the Rockefeller Institute of Government. "I'd assume they imagine they can get rid of the whole thing if they wanted to."

Where the states might have a more credible argument, Gais says, is in Cuomo's statement that the new federal tax law destroyed a century-old tax structure between the federal government and the states.

"The feds and the states share responsibility," says Gais. "[States] need to be able to raise money, especially when there are healthcare proposals that would limit Medicaid expenditures and probably other budget cuts coming at the federal level."

Indeed, no one is disputing the fact that capping how much taxpayers can deduct in state and local taxes from their federally taxable income makes it harder for high-tax states to raise taxes in the future. But Walczak and Gais both said they doubt that amounts to a 10th Amendment violation of a state's right to govern itself. They note that if anything was going to crowd out states' ability to raise taxes, it would have been during the 1950s and '60s, when the federal top marginal income tax rate was 91 percent.

In fact, Walczak says, high-tax states' uproar over capping the deduction is in conflict with the argument often heard within those states that tax rates play a minor role in businesses' and individuals location decisions.

"New Yorkers may favor a larger government and if they want to pay for it, that's a New York decision," Walczak says. "So maybe what we're hearing is that New Yorkers aren't as willing to subsidize that as leaders have been saying."

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