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Final IRS Rules Leave States Few Options for Evading the SALT Cap.

"There is something to upset everyone in the IRS rule."

The IRS has officially blocked one of the ways that high-tax, Democratic states are letting residents circumvent limits on tax deductions.

The 2017 federal tax overhaul imposed a $10,000 cap on state and local tax (SALT) deductions, which can increase what some owe in federal taxes. In response, some states changed their rules to let people "pay" some of their state and local taxes into a state or local charitable trust because federal tax reform did not cap the deductiblity of charitable contributions.

This week, the IRS closed the charitable deduction loophole — and did so in a way that charities say will have a far-reaching impact.

"Wherever you are in the country or on the political spectrum, there is something to upset everyone in the IRS rule," says the National Council of Nonprofits' David L. Thompson.

Furthermore, it might be the first of several moves the federal government makes to end federal tax workarounds.

Other Workarounds

Earlier this year, the IRS indicated that it was "likely" to issue additional regulations to address other efforts by high-tax states to help residents avoid the SALT cap.

So far, only Connecticut and New York have passed other workarounds — both of which are aimed at shifting more of the tax burden to businesses, which are not subject to the cap.

New York created a payroll tax that allows employers to shield their employees from the cap. An employer would reduce an employee's taxable wages while not reducing net take-home pay. Connecticut implemented a similar tax-shifting system for LLCs, which are businesses that file taxes as individuals.

Neither of the workarounds have had much employer participation, largely because they're complicated and require significant understanding and buy-in from employees.

Still, "from the IRS perspective, the workarounds certainly have not gone unnoticed," said Scott Dinwiddie of the IRS Income Tax and Accounting Division at an event in Washington, D.C., earlier this year.

The federal agency hasn't given any indication about when it might issue more crackdowns, but the Tax Foundation's Jared Walczak told Governing this week that the IRS certainly has legal standing to do so.

“With those payroll taxes, there is a legal question,” he says. “That is, whether the business is simply remitting income tax on behalf of their employees.”

In other words, all this shifting around of who’s paying the tax doesn’t change the fact that it started out as an income tax and that is basically still what it is. The packaging may have changed, but the contents remain the same.

In legalese, this is known as the substance-over-form doctrine. It says a taxpayer is bound by the economic substance of a transaction (in this case, the substance is the income tax) even if the substance varies from its legal form (who’s remitting the tax).

What the New Rules Do

That doctrine and another called “quid pro quo” are the basis for the new rules the IRS issued this week.

The IRS essentially expanded the quid pro quo doctrine to tax credits. For example, if someone donates to a charity and receives a tote bag in return, she is supposed to subtract the value of that bag from her charitable contribution when claiming it on tax forms. For residents receiving a tax credit when donating to a charitable trust, they have to now deduct the value of that credit from their contribution. It effectively blocks residents from claiming their entire payment to a state or local trust as tax-deductible.

The new IRS rule squashes charitable-trust-loophole laws passed by Connecticut, New Jersey, New York and Oregon. Similar proposals are pending in California and Illinois.

But the IRS language is so broad that it also applies to long-established state-run trusts (for things like environmental preservation and charter schools), which give out tax credits in exchange for donations. Dozens of states — not just high-tax or Democratically controlled ones — have these trusts. The rule applies to any donation from an individual who has already hit the state and local tax deduction cap.

Plan B and Plan C

State and local governments have two other options: fight the cap in court — or be patient.

A lawsuit filed last July by Connecticut, Maryland, New Jersey and New York argues that the cap violates the U.S. Constitution’s Equal Protection Clause and the 10th Amendment, which protects states’ rights. The suit accuses the federal government of meddling in state taxation and fiscal policies by making it more politically difficult for states to raise revenue.

Many experts say the suit is a longshot.

But New York Assemblywoman Amy Paulin, who represents a New York coalition of localities, school districts and professional organizations, says her group is pushing for the issue to be settled in the courtroom.

“We fully plan to turn to the courts to continue to press the case that this regulation is arbitrary, capricious, unfair and should not be allowed to stand,” she said in a response this week to the IRS ruling.

The other option? Wait it out.

The SALT cap is temporary. It expires in 2025. There's also a proposal in Congress that would repeal the cap, but it's not expected to go anywhere. Some argue that states should simply wait to see if the politics on Capitol Hill shift in a way that diminishes support for keeping the cap.

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