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I.R.S. Warns States Not to Circumvent State and Local Tax Cap

By Alan Rappeport and Jim Tankersley

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WASHINGTON — The Internal Revenue Service is preparing to crack down on states that try to circumvent a new limit on the state and local tax deduction, saying on Wednesday that it will not allow local governments to find creative ways to help individuals fully deduct those taxes.

The I.R.S. warning comes in response to states, like New York, that have looked for ways to blunt the impact of a new \$10,000 cap on the state and local tax deduction, known as SALT. The cap, which was included in last year's \$1.5 trillion Republican tax overhaul, hit predominantly Democratic, high-tax states hardest since it limits the amount of state and local sales, income and property taxes that residents can deduct from their federal taxes.

That has prompted a scramble among local lawmakers to find ways to allow constituents who owe more than \$10,000 to continue to fully deduct those taxes and avoid a tax increase.

The I.R.S. said it would not tolerate states that try to flout the law — a stance that is likely to be challenged in court.

“Despite these state efforts to circumvent the new statutory limitation on state and local tax deductions, taxpayers should be mindful that federal law controls the proper characterization of payments for federal income tax purposes,” the I.R.S. wrote in a notice released on Wednesday.

The I.R.S. notice, which is a precursor to a formal guidance that will need to go through a review process, drew swift condemnation from state lawmakers.

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“New York was the first to take action to protect our residents from this hostile assault and ensure New York families weren’t being used as a piggy bank to pay for tax cuts for big corporations,” Gov. Andrew M. Cuomo of New York, a Democrat, said. “Now, the administration appears poised to attack again through new tax regulations, showing its true hostility to New Yorkers and middle-class taxpayers.”

New York recently began allowing taxpayers to convert local property taxes into charitable contributions, which are fully deductible from federal taxes. Other states, like New Jersey and Connecticut, have been moving forward with similar plans to reclassify state taxes as charitable contributions. New York is also establishing a new system that allows taxpayers to convert their state income tax to a payroll tax, which companies would pay on their behalf and then deduct from their federal tax bill.

While Wednesday’s notice is focused on the charitable deduction scheme, a senior Treasury official said the department was planning to roll out more I.R.S. notices dealing with other potential loopholes in the tax law. The notice, the official said, was intended to serve as a broad warning to states to avoid developing more “gimmicks.”

Gov. Philip D. Murphy of New Jersey, a Democrat, said he was certain the state’s legislation was lawful and that the I.R.S. was putting politics over policy. He said the federal government’s policy on charitable deductions has become inconsistent, which could open it to legal challenges.

“For the federal government to permit certain states to allow for charitable deductions, but not others that are following the same principles, is unconscionable,” Mr. Murphy said. “I remain committed to fighting the SALT deduction tax cap and am confident that the solution signed into law can and should be embraced by the I.R.S.”

While the I.R.S. notice was intended to formally explain where the federal government stands on the issue, the ensuing fight might make the situation all the murkier.

Richard LaBarbiera, the mayor of Paramus, N.J., and one of the early supporters of New Jersey's attempt to help taxpayers, said the I.R.S. notice could help states get clarity on what is allowed under the new law.

"The thing that I had reservations about was asking or offering this program to the residents with the uncertainty when they go file their taxes what the I.R.S. was going to say," he said. "I'd rather see this decided in advance before we accept a single dollar."

Last year, residents in many states tried to prepay their 2018 property taxes before the new law took effect, but the I.R.S. took action to limit that option.

Efforts to restrict the state and local tax deduction were controversial and prompted several Republican lawmakers from high-tax states to vote against the tax bill. The \$10,000 cap was imposed as a way to offset some of the cost of other individual and business tax cuts.

The Treasury Department and the I.R.S. are worried that the workarounds could further balloon the cost of the tax cuts, which are projected to add more than \$1 trillion to the national debt over a decade.

In January, Steven Mnuchin, the Treasury secretary, scolded states that were looking for loopholes.

"I hope that the states are more focused on cutting their budgets and giving tax cuts to their people in their states than they are in trying to evade the law," he said.

On Wednesday, Representative Kevin Brady of Texas, the Republican chairman of the Ways and Means Committee, praised the I.R.S. for taking action.

"It's unfortunate that some politicians are still trying to discredit this new economic momentum in defense of high taxes and stagnant growth," Mr. Brady said. "I applaud the administration for responding to these gimmicks."

Jared Walczak, a senior policy analyst at the Tax Foundation in Washington, which has long criticized the state and local tax deduction, said the I.R.S. appeared to be moving toward a "substance over form" doctrine for evaluating whether payments made in exchange for the new state tax credits qualify as charitable deductions. The I.R.S. test,

he said, would look at whether states devised the payments to allow residents to circumvent federal tax liability. He said there is support in past regulations and court rulings for such a standard.

“What seems very clear is that the I.R.S. is neither fooled by nor particularly flummoxed by recharacterization of federal tax liability,” he said.

But some tax experts warn that the I.R.S. could unintentionally hurt taxpayers who benefit from longstanding state tax credits for charitable contributions, including those for college and private K-12 school tuition, and wind up treating states disparately.

“State tax credits for charitable contributions to qualifying organizations in a state have historically been respected as charitable contributions in federal law, and indeed the I.R.S. once issued a memorandum to that general effect,” said Itai Grinberg, a tax professor at Georgetown University’s law school.

The prospect of the I.R.S. determining that a contribution to a private or religious school would be deductible, but a contribution to a charitable fund established by a public school district or by the public school district’s parents’ association would not be deductible “just seems both hard to maintain on its face and politically difficult to reach,” Mr. Grinberg said.

Carl Davis, the research director for the Institute on Taxation and Economic Policy in Washington, said that Alabama provides a 100 percent state tax credit for taxpayers who donate money to organizations that give children vouchers to attend private school. Under its new law, New York gives an 85 percent state tax credit to residents who donate to a state fund that supports education.

Treating Alabama taxpayers as compliant with I.R.S. law but New Yorkers as not would be largely indefensible, he said.

Daniel Rosen, a partner at the law firm Baker McKenzie, said that the I.R.S. is likely to face litigation to block its efforts.

“This notice was issued with the intention of dissuading taxpayers from making donations to state charitable contribution funds,” Mr. Rosen, who is a former lawyer for the I.R.S., said. “I would anticipate challenges to this notice fairly quickly.”

Nick Corasaniti contributed reporting from New Jersey.

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