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SHOP TALK

Potential IRS Challenges to SALT Deduction Limitation Workarounds

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Shortly after the Tax Cuts and Jobs Act ("TCJA") was enacted, New York Governor Andrew Cuomo described the new $10,000 state and local tax deduction limitation as an "economic missile" launched by the federal government at New Yorkers and others living in blue states. It did not take long for professors, state legislators, and tax planners to develop ways to circumvent the $10,000 limitation. Asked to comment on one of the workarounds, Treasury Secretary Steven Mnuchin derided it as "ridiculous"; the IRS has since announced plans to undercut that same workaround by regulation.

At this juncture, the fight over the $10,000 limitation has already become something of a tug-of-war with the IRS pitted against blue state governments and taxpayers. It would not be terribly surprising if the tug of war ultimately results in a courtroom battle. This article discusses a few of the workarounds designed to circumvent the $10,000 limitation and potential IRS responses.

Workaround one—charitable contributions

The most widely discussed workaround, which relies on the charitable contribution deduction, was popularized by tax law professors, who posted an article setting forth the basic idea in early 2018.[1] Under the workaround, localities develop "charities" and taxpayers "donate" the amount of property tax they otherwise owe to the "charities," receiving a property tax credit for the donation. For federal tax purposes, taxpayers then claim a "charitable contribution" deduction, which is not subject to the $10,000 limitation. Effectively, then, the workaround converts a property tax payment (subject to a $10,000 limitation) to a charitable contribution (freed from the $10,000 limitation).

To illustrate how this works, suppose taxpayer T owes $50,000 in property tax to the X County Assessor. Rather than pay the assessor, T instead donates $50,000 to X County charity. T's $50,000 donation is creditable against the X County property tax owed, so T now owes no property tax. For federal income tax purposes, T can deduct the entire $50,000 payment as a charitable donation, whereas T would have been limited to a $10,000 deduction if T instead paid the $50,000 property tax bill.

The IRS responds—Notice 2018-54

Roughly nine states have considered, and at least three states have enacted, legislation authorizing the charitable contribution workaround described above.[2] Fearing a drain on federal coffers, and after Secretary Mnuchen denounced the workaround as "ridiculous," the Treasury Department responded by issuing Notice 2018-54, which warns that "federal law controls the proper characterization of payments for federal income tax purposes" and which announces that "the Treasury Department and the IRS intend to propose regulations" in this area.[3] The proposed regulations will "make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers."[4]

Relying on "substance-over-form" could mean a case-by-case inquiry into the motivations prompting charitable deductions, and the substance behind them, although it seems like it would be easiest for the IRS to simply create a bright-line rule that charitable contributions creditable against property taxes are not deductible (notably, the IRS presumably will want to avoid eliminating deductions for donations to pre-existing state programs that give rise to a state income tax credit).[5]

Whatever the language in the proposed regulations ultimately turns out to be, it is hard to imagine a scenario in which anyone could feel comfortable relying on the charitable contribution workaround in the near future. However, as of this writing, the regulations have not been issued, so this is very much a "wait and see" evolving area.

Workaround two—state payroll tax

A second workaround, also popularized by tax law professors, is comparatively more complicated than the charitable contribution workaround. It involves replacing state personal income taxes with a payroll tax paid by employers. Employees would be paid slightly less with the difference in salary being taken into account as part of the payroll tax paid by the employer, with the employee receiving a wage credit or wage exclusion. Correctly designed, the end result is that the employee and employer are in the same economic position as they would be absent the $10,000 limitation with the employee reporting less income for federal income tax purposes, due to the wage decrease.

New York has enacted a payroll tax based on the above principles, and has made it optional (in other words, employers can opt-in to the payroll tax if they so choose).

The payroll tax has a few problems. First and foremost, it is not easily implementable[6] and may not be easy to explain to employees, either (try convincing employees that although their wages are decreasing they will nonetheless be better off economically). Complications can arise for larger companies that have employees in multiple states or that have New York nonresident employees that work in New York. Such employees would receive less wage income under the payroll tax but would not receive a corresponding credit or exclusion to make up the difference in their state of residence. For these reasons, as well as others, employers are generally not opting into the payroll tax system.

In the case of employers that do opt in, it is possible that the IRS could attempt to challenge the deductibility of the employer-level payroll tax, meaning that by "opting in" to the payroll tax system the employer also runs a risk of "opting in" to a multi-year IRS tax dispute.

With that said, Notice 2018-54 focuses on the charitable contribution workaround, not the payroll tax, so it is at least possible that the IRS would not challenge the deductibility of payroll tax deductions taken by employers.

Workaround three—trusts

Some estate planners and financial advisors are advising clients to consider a third workaround under which non-grantor trusts are used to skirt the $10,000 limitation.

To illustrate how this works, recall Taxpayer T that is subject to $50,000 in property tax. Under the trusts workaround, T transfers title to the property to a new LLC ("New LLC"), the membership interests of which would each be owned 20% by five non-grantor trusts. New LLC would pay $50,000 in property taxes to the local county, with each of the five trusts then deducting its proportionate share ($10,000) of the payment. Assuming the workaround is respected by the IRS, the trusts controlled by T now in the aggregate would be able to deduct the entire $50,000, and the $10,000 limitation would be avoided.

While this technique is elegant in concept, there are some practical issues. For example, assume that T's annual property tax is $150,000, rather than $50,000. To receive the full benefit of the $150,000 deductible payment, T would then need to set up 15 trusts, which might be more of a hassle than it is worth. Additionally, a deduction is valueless unless there is income that it can offset. Therefore, T would need to ensure that each trust has at least $10,000 in income that the deduction would absorb. And, of course, there is also the problem of getting any money or assets out of the trusts, should that ever be desirable.

Managing such an arrangement year-to-year might make sense for some people that already have a complicated trust and estate plan in place, with professionals monitoring it, but probably not for most taxpayers. Additionally, there is also some risk that the IRS could eventually seek to challenge the use of trusts to circumvent the $10,000 limitation, although the IRS has not indicated that it intends such challenges as of this writing.

Conclusion

It is an old story: painful tax legislation is enacted and tax planners immediately go to work developing tax planning techniques. But there are some singular, or at least non-standard, aspects of the fight over the $10,000 limitation, including: (1) the concentration of impacted taxpayers in select states; (2) the federal/blue state tension; (3) the unlikely alliance between blue state governments and taxpayers; and (4) the surprising sight of tax professors advocating workarounds that tax practitioners caution seem a bit too aggressive (usually the roles are reversed). This is certainly an area to closely monitor in the coming months, especially the proposed regulations promised in Notice 2018-54.

[1] *See* Joseph Bankman, et al, *Federal Income Tax Treatment of Charitable Contributions Entitling Donor to a State Tax Credit,* (Jan. 8, 2018), UCLA School of Law, Law-Econ Research Paper No. 18-02; UC Hastings Research Paper No. 264. Available at SSRN: https://ssrn.com/abstract=3098291 or http://dx.doi.org/10.2139/ssrn.3098291.

[2] *See, e.g.,* Connecticut S.B. 11 (P.A. 18-49); New Jersey S. 1893 (P.L. 2018, c.11); New York S. 7509, (P.L. 2018, c. 59).

[3] *See* Notice 2018-54.

[4] *Id.*

[5] Oregon is one state that offers state income tax credits for donations to state/local charities.

[6] A paper published by the Tax Foundation used harsher language, describing the payroll tax as "an administrative nightmare." *See* Jared Walczak, *New York's SALT Avoidance Scheme Could Actually Raise Your Taxes,* Tax Foundation, April 2, 2018.