IRS Throws Salt in the SALT Deduction Limit Wound

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The Tax Cuts and Jobs Act of 2017 introduced a limit for deductions on state and local taxes. Some states hoped to get around that through charitable contributions. But the IRS says no.

In August of 2018, the IRS released new proposed regulations (technically, they are amendments to existing regulations) to deal with states' recent attempts to circumvent the state and local income tax (SALT) deduction limit that was put into place by the Tax Cuts and Jobs Act. In short, the proposed regulations effectively eliminate the strategy of donating to state-run "charities," for which you receive a credit against state taxes, and a deduction for a charitable contribution for federal income tax purposes.

BACKGROUND

There have long been states offering a credit against state taxes for contributions made to certain charitable organizations. In such instances, the amount of the credit received was essentially a payment of state taxes. Nevertheless, many individuals would still treat the full amount of their contributions as a charitable deduction on their federal income tax return.

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In general, a charitable contribution cannot involve any sort of quid pro quo, such as the promise of something of value in return for the contribution… a la a tax credit. Accordingly, this is why, when you donate $1,000 and receive a "free" T-shirt in return, you usually get a letter in the mail thanking you for your donation, and letting you know that $995 of your $1,000 donation is a charitable contribution. The $5 difference is the value of what you received in exchange for the donation, and thus, is not eligible for deduction as a charitable contribution on your federal income tax return.

Correspondingly, the receipt of a credit for state income taxes—which is a dollar for dollar reduction in state tax liability—clearly has value and can easily be considered a quid pro quo. If viewed in such a manner, the credit would negate the donation's value as a charitable contribution for federal income tax purposes.

In the past, the IRS chose not to formally address this matter, providing no official guidance as to whether the receipt of a state tax credit for a "charitable contribution" would negate the contribution's eligibility for deduction for federal income tax purposes. Even in informal guidance, the IRS was largely ambivalent to the matter. But why?…because, quite frankly, it didn't matter for the vast majority of people.

Prior to the passing of the Tax Cuts and Jobs Act, individuals were generally allowed to claim a deduction for charitable contributions of up to 50% of their adjusted gross income (AGI), which more than covered most people. Furthermore, a deduction was also available for an unlimited amount of state and local income and property taxes paid.

Thus, the IRS really didn't care how a taxpayer would report the amounts in question. After making a contribution to a charity and receiving a state income tax credit, an individual was either going to receive a deduction for a charitable contribution on their federal income tax return, or a deduction for the payment of state and local taxes. It simply amounted to putting the deduction on a different line of the return, but didn't actually impact the calculation of taxes. As such, it wasn't a high priority issue for the IRS.

Note: A significant exception to this general rule existed for taxpayers subject to the alternative minimum tax (AMT). Under the AMT, deductions for charitable contributions are largely unaffected, but deductions for the payment of state and local taxes deduction are eliminated.

The Tax Cuts and Jobs Act changed this calculation, however, by limiting the SALT deduction to a maximum of $10,000 ($5,000 for married couples filing separate returns). Thus, there is a new pronounced and obvious advantage to treating amounts as charitable contributions for federal income tax purposes, and not the payment of state and local taxes. There is generally opportunity to deduct charitable contributions up to much higher limits.

Capitalizing on this possibility, and the IRS's lack of any sort of formal guidance on the matter up until this point, many high-tax states rushed to create new state-run "charities" for which contributions would be eligible for a state tax credit. This raised red flags at the IRS, pushed the matter up the priority list, and ultimately culminated in the release of the proposed regulations.

WHAT DO THE SALT REGULATIONS SAY?

In perhaps the least surprising move in history, the IRS struck down states' attempts to help their taxpayers circumvent the new SALT limits . Simply put, the "I'm-going-to-'donate'-money-to-a-charity-to-receive-a-state-tax-credit-AND-a-full-charitable-deduction-on-my-federal-return" strategy is NOT going to work.

In the event a taxpayer receives a credit for state taxes for a contribution to a charity, the value of the credit received will generally reduce the amount of the contribution that is eligible to be claimed as a charitable contribution on an individual's tax return. The lone exception to this rule is for state and local tax credits that do not exceed 15% of the amount contributed to the charity. At that level, the math doesn't really add up, and unless charitable intent is the primary goal—and not federal income tax avoidance—the contribution is no longer "worth making." Sorry folks. Remember, I'm only the messenger.

CAN THE SALT DEDUCTION LIMIT STILL BE BEAT?

While the proposed regulations released yesterday are definitely not what people in states like New York, California, Hawaii, New Jersey and Massachusetts wanted to hear, it's certainly not the end of the SALT-deduction-limit battle. For instance, several of the aforementioned states, along with others, have filed suit in federal court, seeking to strike down the SALT limit as unconstitutional. Frankly, as much as I'd like to see them win that suit to lower my own tax bill, I give it about the same chance as I do the Jets winning the Super Bowl this year. Translation: it ain't happening (apologies to all the Jets fans out there).

There is, however, another, more realistic, way for states to potentially help their taxpayers "beat" the SALT deduction. In essence, states can look to find ways to transition more taxes to be paid by employers. It's more complicated, and would have potentially much broader side effects, but it could work.

Under the Tax Cuts and Jobs Act, the SALT deduction limit does not impact a business's ability to deduct an unlimited amount of taxes paid; a point the legislation explicitly went out of its way to make. Thus, if states can find a way to shift (more of) the tax burden from individuals to employers, it could lower the rates for individuals and minimize the SALT limit's impact on its taxpayers, and all while keeping revenues in line with today.

States like New York and California have been exploring this idea, but figuring out how to make such a massive change in tax policy will take time. That said, the torching of other strategies by the IRS in yesterday's proposed regulations may push states to get more creative faster.

Buckle your seat belts. It's going to be a wild ride for the next few years as we continue to deal with the Tax Cuts and Jobs Act's massive changes.

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