The Death Knell for SALT Cap Workarounds?

Treasury's Final Regulations Uphold the $10,000 Cap

By Kevin M. Flynn

The itemized deduction for state and local taxes (SALT) under Internal Revenue Code (IRC) section 164 had long provided relief to taxpayers residing in high income and property tax states such as New York, New Jersey, and Connecticut. It assured these taxpayers that their federal tax obligation would only be computed after a reduction for the state and local taxes that they paid, subject to the application of the alternative minimum tax and the itemized deduction limitation. The SALT deduction meant that the IRS could not impose a double tax on that portion of a taxpayer's income that had been paid in taxes to state and local taxing authorities.

On December 22, 2017, President Donald J. Trump signed the Tax Cuts and Jobs Act (TCJA), which represents the most significant overhaul of the country's tax laws since the Tax Reform Act of 1986. A major component of the TCJA was a $10,000 per calendar year cap on an individual's aggregate deduction for state and local income, property, and sales taxes [IRC section 164(b)(6)]. This limitation applies to tax years beginning after December 31, 2017, and ending before January 1, 2026.

SALT Cap Workarounds

The SALT cap was loudly criticized by governors of states such as New York, New Jersey, and Connecticut. The governors in these and other high-tax states maintain the cap reflects an anti–blue state agenda masquerading as tax reform. In response, many elected officials from high-tax states publicized evidence showing that their states contributed far more tax revenue to federal coffers than they received back.

High-tax states pushed the battle one step further, however, by enacting or expanding "workarounds" to the SALT cap. The workarounds took various forms, but they were all designed to avoid or mitigate the effect of the SALT cap for those who had lost a portion of their state or local tax deductions. For example, New York and New Jersey created or expanded programs that allowed taxpayers to make donations to state- and local-sponsored charitable funds or trusts described in IRC section 170(c) in exchange for tax credits against their state and local tax obligations. The intention of these programs was to permit taxpayers to then deduct the donations as charitable contributions on their federal income tax returns under IRC section 170(a)(1), which contributions were not limited under the TCJA. These programs were viewed as an effective means of circumventing the SALT cap.

The Final Regulations

On June 13, 2019, the U.S. Treasury Department and the IRS published final regulations that put the kibosh on state and local charitable contribution programs like those described above. The final regulations also put an end to similar contributions made by a trust or decedent's estate under IRC section 642(c). The regulations became effective on August 12, 2019, and apply to charitable contributions made after August 27, 2018.

The regulations provide that a taxpayer who makes a payment to an entity identified in IRC section 170(c) must reduce the amount of the charitable contribution deduction under IRC section 170(a)(1) by the amount of the state or local tax credit that the taxpayer receives or expects to receive in "consideration" for the payment [Treasury Regulations section 1.170A-1(h)(3)(i)]. For example, assume that a state operates an 80% state tax credit program, and a taxpayer who itemizes deductions makes a $10,000 charitable contribution to the program. The final regulations require that the taxpayer reduce the $10,000 contribution by the $8,000 state tax credit, leaving a contribution deduction of $2,000. The regulations regard the state or local tax credit as a quid pro quo provided in exchange for the charitable contribution; this is based on the longstanding rule for charitable contributions that requires a taxpayer to reduce his contributions deduction by the value of any "goods or services" received from the donee.

To reach its ruling in the final regulations curtailing state tax credit programs, the IRS had to broadly retreat from established case law precedent, as well as its own administrative guidance. Indeed, in IRS Chief Counsel Advisory 201105010 (Oct. 27, 2010) (2010 CCA), the IRS ruled that a taxpayer could deduct the full amount of a charitable contribution made in exchange for a state tax credit without reduction for the value of the credit received in return. Similarly, in *Tempel v. Comm'r*, 136 T.C. 341, 351, n. 17 (2011), the Tax Court rejected the view that "a state's grant of state income tax credits to taxpayers who make charitable donations … should be treated as a transaction that is in part a sale and in part a gift." The Tax Court noted in its opinion in *Tempel* that the IRS agreed with this result. In the commentary to the final regulations, the IRS conceded that its new position departed from the 2010 CCA "in important respects."

4/4/22, 4:13 PM The Death Knell for SALT Cap Workarounds? Treasury's Final Regulations Uphold the $10,000 Cap - KFLaw I Flip PDF Online | Fli…

While they invalidate workaround arrangements that provided state and local tax credits in exchange for charitable contributions, the final regulations do allow charitable contributions under IRC section 170(a)(1) for programs that grant dollar-for-dollar state or local tax deductions rather than tax credits. The regulations do not apply the quid pro quo analysis to SALT deductions; the Treasury Department and the IRS reasoned that the economic benefit of a dollar-for-dollar deduction is limited because it is based on a taxpayer's state and local marginal tax rates. Therefore, the risk of a taxpayer using state or local tax deductions to avoid the $10,000 cap under IRC section 164(b)(6) was considered comparatively low.

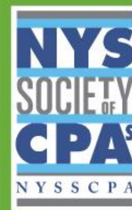
The final regulations also include a de minimis exception, which provides that the prohibition of a charitable deduction for state and local tax credits will not apply if the total amount of the tax credits received or expected to be received by the taxpayer is 15% or less than the charitable donation. This exception reflects the recognition by the Treasury Department and the IRS that the combined top marginal state and local tax rates in each of the 50 states and the District of Columbia does not exceed 15%. The Treasury Department and the IRS consider the 15% de minimis exception as generally providing a benefit on par with the dollar-for-dollar exception for state or local tax deductions.

The States Sue

On July 17, 2019, the attorneys general of New York, New Jersey, and Connecticut filed a lawsuit against Treasury and the IRS in the U.S. District Court for the Southern District of New York challenging the validity of the final regulations. The complaint seeks declaratory and injunctive relief against the Treasury Department and the IRS. The suit asks the court to bar implementation of the final regulations on the grounds that they impermissibly undermine charitable giving by eliminating programs that provide state and local tax credits in exchange for charitable donations. The complaint alleges that the final regulations are unlawful under the Administrative Procedures Act because they are inconsistent with the express meaning of IRC section 170, and are arbitrary, capricious, and an abuse of discretion.

The lawsuit filed by New York, New Jersey, and Connecticut against the Treasury Department and the IRS ensures that the battle over the $10,000 SALT cap will continue into the upcoming national election cycle. ❑

***Kevin M. Flynn, JD, LLM**, is a partner at Kostelanetz & Fink, LLP, New York, N.Y.*



NYSSCPA **Thanks** Its Corporate Partner Program Advertisers:

Corporate Partner

PAYCHEX®
Payroll | Benefits | HR | Insurance

Supporting Partners

NYSSCPA MEMBER INSURANCE PROGRAM

Arnold Standard Cos. Cost Control Services

CPACHARGE — AN AFFINIPAY SOLUTION

First Republic — It's a privilege to serve you®

If you are interested in learning more about NYSSCPA's Corporate Partner Program, contact **Darlene Rives** at **410.584.1971** or **darlene.rives@mci-group.com**

https://online.flipbuilder.com/KFLaw/pdnq/mobile/index.html 2/3