

State Tax Observations

Battle Brewing: NY, NJ and CT Circumvent the Federal Income Tax SALT Deduction Limitation as the IRS Punches Back

By Daniel Efron, CPA, Partner, Alan S. Kufeld, CPA, Partner and Sandy Weinberg, JD, Principal

It may not be an Infinity War, but a tax battle is heating up between some states and the IRS. The fight is over the new federal limitation on the state and local tax (SALT) deduction that individuals can take on their federal income tax returns.

Until 2018, individuals itemizing deductions on their federal income tax returns were permitted to deduct the entire amount of SALT paid each year in computing their regular tax liability. (The SALT deduction has always been an addback for those paying the Alternative Minimum Tax.) This amount includes state, city and local income taxes as well as real estate taxes paid. Last December's Federal Tax Cuts and Jobs Act (TCJA) capped the annual amount at \$10,000 (at least through 2025).

Protests from high income tax states such as New Jersey, New York, Connecticut, Illinois and California were swift and vocal as citizens of those states are facing increased federal income taxes attributable to the \$10,000 deduction cap. (That the potential increase in tax is offset to a significant degree by lower tax rates, a higher standard deduction and an increased alternative minimum tax threshold has not been raised by the states in their protests.)

Said differently, taxpayers in these states now feel the full brunt of their state and local tax burden without any federal tax benefit. The \$10,000 cap may not affect residents of lower income states like Alabama or Arkansas, but the Tax Policy Center says the average New Yorker's SALT deduction was \$22,169. In New Jersey and Connecticut, those amounts were \$17,850 and \$19,665, respectively. This is a "red state - blue state" issue since many high tax states often support Democratic candidates.

This article addresses the New York, New Jersey and Connecticut legislative responses to the new SALT deduction limitation, as well as the IRS counter-response and the states' reaction to the IRS. Let's get ready to rumble.

Blue States Spring into Action

New York

From day one, New York's Governor Cuomo loudly voiced his opposition to the SALT deduction limitation. Cuomo is keenly aware that the loss of this federal deduction will be felt in the pocketbooks of thousands of New York residents who pay some of the highest amounts of state and city income and property taxes.

To preserve the SALT deduction benefit, the Governor recently signed budget legislation including two key provisions impacting the SALT deduction limitation. The first established a charitable gift trust fund at the state level and includes provisions for local governments to set up similar funds. Taxpayers can make

charitable contributions to such funds and receive a New York personal income tax credit in the amount of 85% of such amounts contributed in the previous tax year. The tax credit will be available beginning in 2019 for contributions made during 2018. The charitable contribution can also be claimed on the taxpayer's federal tax return for the year the contribution is made by those taxpayers who itemize their deductions.

The second provision aimed at preserving the benefit of the SALT deduction is a rather complex optional payroll tax deduction for payroll paid to covered employees by companies electing to participate in this program. The employer would incur a payroll tax and receive a tax deduction of 1.5% of covered employee's salary in 2019, 3% in 2020 and 5% in 2021 and thereafter. This tax would be levied on the payroll paid to "covered employees" (i.e., employees whose annual wages are in excess of \$40,000). Employers who elect to participate are prohibited from deducting this payroll tax from the employee's wages. The election to participate in this program must be made by December 1 and will take effect for the immediate following year. The election must be made by a member, owner or other individual with authority to bind the entity or to sign tax returns.

An employee who is impacted by this provision will receive a New York personal income tax credit equal to the product of a) the employee's taxable wages in excess of \$40,000, b) 1.5% (for 2019), and c) one minus a fraction equal to the New York State personal income tax (before any credits) over the employee's state taxable income. The rate under b) increases to 3% in 2020 and 5% in 2021 and thereafter.

New Jersey

In May, New Jersey Governor Murphy signed into law a provision aimed squarely at preserving the benefit of the state tax deduction for New Jersey residents. The new law permits the establishment of charitable funds by New Jersey counties, municipalities and school districts. Once established, taxpayers are permitted to make charitable contributions to these funds. While the \$10,000 cap on state taxes remains in place, individuals who make contributions to these funds receive a credit on their property tax bills for up to 90% of the amount contributed. The amount contributed is deductible as a charitable contribution on the individual's federal tax return thus preserving the prior federal SALT deduction in a workaround fashion.

Connecticut

Connecticut's new law, signed by Governor Molloy on May 31, 2018, contains two provisions designed to mitigate the impact of the federal SALT deduction cap.

The first provision imposes an entity level tax on partnerships, S corporations and limited liability companies taxed as partnerships conducting business in Connecticut. While the entity is taxed, owners of the entity receive a tax credit against their Connecticut personal income tax for their portion of the entity level tax paid. This approach shifts the payment of state tax from the individual to the entity. Entities have no SALT deduction limitation on their income taxes. The law protects business owners but does not benefit wage earners who do not own an interest in a passthrough entity.

The law also includes a proposal similar to those enacted in New York and New Jersey that would permit municipalities to create charitable organizations which would provide services to the municipality. Taxpayers can make contributions to such organizations and receive a tax credit against their property taxes.

Caveat Emptor: The IRS Responds to State Proposals

In a widely anticipated move, the Internal Revenue Service recently issued Notice 2018-54 to stave off some of the legislation discussed above to recast as charitable contributions payments intended to satisfy a taxpayer's state or local tax liabilities. The IRS intends to shut down this maneuver designed to avoid the TCJA's 2018 SALT deduction limit. The Notice informs taxpayers that the IRS intends to propose

regulations dealing with the federal tax treatment of certain payments made by taxpayers for which they may receive a credit against their state and local taxes. The IRS noted that the proposed regulations would be largely directed by substance-over-form principles of tax law, reflecting the true intent or purpose of the transaction.

The IRS reminded taxpayers that federal law controls the characterization of payments for federal tax purposes. Substance over form looks to the economic realities of a transaction (payments to the fund are controlled by the state) rather than the formalities employed by simply making payments to a “charitable” fund. The expected release date of the regulations was not provided in the IRS Notice.

The States React

Reaction to the IRS Notice was swift as New York Governor Cuomo vowed to “fight this economic missile with every fiber of our being” and stating that the IRS is “being used as a political weapon.” New Jersey Attorney General Grewal issued a statement that the charitable contribution concept was supported by policy and precedent.

Proceed With Caution

Stay tuned. State workarounds to the SALT deduction limitation may yet come to fruition. Some may not survive. In any event, the ultimate benefit will depend on your particular set of facts. A cautious approach may be prudent. We’ll be monitoring the developments. Remain informed.

Contact Us

For questions concerning your tax situation, contact any of the following or your PKF O’Connor Davies tax advisor:

Sandy Weinberg, JD
Principal
sweinberg@pkfod.com | 203.705.4170

Alan S. Kufeld, CPA
Partner
akufeld@pkfod.com | 646.449.6319

Daniel Efron, CPA
Partner
deffron@pkfod.com | 551.249.1732

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