WRMarketplace

An AALU Washington Report

The *WR Marketplace* is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led by **Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirus, and Rebecca S. Manicone.** WR Marketplace #18-08 was written by **Shareholder Jonathan M. Forster and Associate Jennifer M. Smith.**

The *AALU WR Newswire* and *WR Marketplace* are published by the AALU as part of the *Essential Wisdom Series,* the trusted source of actionable technical and marketplace knowledge for AALU members—the nation's most advanced life insurance professionals.

Thursday, 22 February 2018 **#WRM 18-08**

TOPIC: What Happened to Tax Relief? Some States Look to Offset Limited SALT Deduction.

MARKET TREND: To limit the appeal of an out-of-state move, states with higher income, sales, and/or property taxes are exploring ways to reduce the impact of the new limit on the federal income tax deduction for state and local taxes ("SALT") on their individual residents.

SYNOPSIS: The Tax Cuts and Jobs Act (the "Act") limits the federal income deduction for personal SALT to just $10,000, whether taken by an individual tax filer or a married couple filing jointly. The provision significantly affects individuals in high tax states, who may see their tax liability increase, despite reductions in federal individual tax rates. To mitigate the impact on their residents and the potential incentive to relocate to lower tax jurisdictions, some higher tax states, such as California and New York, have issued targeted proposals that generate a charitable deduction for state tax payments, which would place their residents in close to the same position as if the full SALT deduction was available. Oregon and New Jersey are considering similar options. The implementation and effectiveness of these proposals, however, remains to be seen.

TAKE AWAYS: Regardless of whether the states enact these proposals, individual taxpayers bear the ultimate tax burden, either because of the limited SALT deduction or

the risk of IRS audit and potential disallowance if they take a larger, state-created charitable deduction. Taxpayers will need to confer with their financial, legal, and tax advisors to secure tax projections for 2018 and determine whether taking any available state-created charitable deduction makes sense given their circumstances and potential risks.

WHAT HAS CHANGED

In exchange for doubling the standard individual tax deduction (up to $12,000 for single filers and $24,000 for married, joint filers), the Act dramatically limits the ability of individuals to take itemized deductions. Possibly the most significant change is the capping of the individual federal income tax deduction for personal SALT to an aggregate of $10,000, which includes: (1) property taxes on homes used for personal purposes and (2) either state income or sales taxes.[1] The same $10,000 limit applies both to single filers and married joint filers. For example, if an unmarried couple splits payments on $20,000 of property taxes on a personal residence, each person could take a SALT deduction of $10,000 ($20,000 total). If the couple is married, however, they can only take a $10,000 deduction.

WHY IT MATTERS

This limitation especially affects residents in higher tax states, where the average SALT deduction often exceeds the $10,000 limit, including in particular New York ($22,169 average individual SALT deduction), Connecticut ($19,665), California (18,438), and New Jersey ($17,850), to name a few.[2] Residents in these states ***could see their overall tax liability increase***, despite the Act's reductions in federal individual tax rates.

> ***Simple Example:*** H and W are married, successful professionals living in California. They have $600,000 of annual income, all from wages, in both 2017 and 2018, and are subject to California income taxes of $73,800 in each year (at a 12.3% rate). The state income taxes are their only deduction eligible for itemization. In 2017, they itemize, taking a SALT deduction for the full $73,800 of their California income tax liability. In 2018, however, they take the standard deduction of $24,000, as their SALT deduction is limited to just $10,000. Compare their relative federal income tax liabilities in each year:

Federal Taxes	**2017**	**2018**
Gross Income	$600,000	$600,000
Applicable Deduction	$73,800 (Itemized SALT deduction)	$24,000 (Standard deduction)

Taxable Income	$526,200	$576,000
Applicable Tax Rate	39.6%	37%
Tax Liability	$208,375	$213,120
Effective Tax Rate	34.7%	35.5%

HOW STATES ARE RESPONDING

Notably, while the Act limits the federal SALT deduction, it retains the charitable income tax deduction rules and expands the deduction for charitable contributions of cash to public charities by increasing the adjusted gross income limitation on such contributions from 50% to 60%. Accordingly, several states have introduced or are contemplating legislative or administrative proposals that attempt to reduce the impact of the SALT deduction limitation by providing individual residents with the option to make contributions to state-sponsored charitable funds. Arguably, these contributions would be eligible for the federal charitable income tax deduction, thus offsetting the limited federal SALT deduction. Specifically:

New York. The Governor's recent budget proposal includes legislation that would create two new state Charitable Contribution Funds to accept donations for purposes of improving health care and education in New York, which presumably would qualify for the federal charitable income tax deduction. Any taxpayer making such a donation also could claim a state tax credit equal to 85% of the donation amount. School districts and other local governments also would be authorized to create charitable funds for education and health care to receive donations that would provide a reduction in local property tax bills (via a local credit) equal to a percentage of the donation.[3]

California*.* Like New York, California bill SB 227 also would create a state-sponsored charitable fund (the California Excellence Fund), with the intent of generating a federal income tax charitable deduction and providing an 85% credit against the California income tax for donations made to the fund.

Other States. Oregon has developed a proposal like California's, and New Jersey's Governor has indicated that his state is looking into a similar plan.

WILL IT WORK

The above approach relies heavily on IRS Chief Counsel Advice ("**CCA**") Memorandum 201105010, which addressed whether cash payments to state agencies could be considered charitable contributions despite the state tax credits received by the taxpayer as a result. The CCA stated that a cash payment to a state agency "is treated for federal tax purposes as a reduction or potential reduction in tax liability," and "not as a return benefit that negates charitable intent, reducing or eliminating the deduction itself." Yet, the CCA also noted that "there may be unusual circumstances in which it would be appropriate to recharacterize a payment…that was, in form, a charitable

contribution as, in substance, a satisfaction of tax liability," which presumably would not qualify for the charitable deduction.

As this CCA predates the SALT deduction limitation, and CCAs, generally, have no precedential value and cannot be relied on by taxpayers, it does not provide any assurance that the IRS will uphold these state-proposed charitable deductions. Given that the SALT deduction limitation provides revenue designed to offset other tax reductions made by the Act, it is possible that the IRS will withdraw the CCA, issue alternative guidance that directly addresses these proposals, or seek federal legislation that pre-empts these state laws, if enacted.

OTHER OPTIONS

The benefits of the above proposals may not materialize or be adopted by other states. In this case, individuals seeking to mitigate the impact of the limited SALT deduction may consider relocating to a lower tax state (similar considerations may apply to non-grantor trusts, which may seek to transfer their situs to a lower tax jurisdiction). Alternatively, there likely will be continued interest in income-deferral options for asset allocation and deferred compensation purposes, including the use of annuities or life insurance, as the income tax treatment of these assets remains unchanged, based on long-standing and appropriate tax principles.

TAKE AWAYS

Regardless of whether the states enact these proposals, individual taxpayers bear the ultimate tax burden, either because of the limited SALT deduction or the risk of IRS audit and potential disallowance if they take a larger, state-created charitable deduction. Taxpayers will need to confer with their financial, legal, and tax advisors to secure tax projections for 2018 and determine whether taking any available state-created charitable deduction makes sense given their circumstances and potential risks.

DISCLAIMER

This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

NOTES

[1] Act §11042. The SALT deduction limitation is effective beginning in 2018 and will sunset after December 31, 2015. Note that the SALT limitation does not apply to property taxes on real property held for rental or to sales taxes paid in connection with a business, although it does apply to state income taxes paid on income from a business. For example, if an investor owns a rental property and pays $20,000 in property taxes on the property, those property taxes can be deducted, but the state income taxes resulting from this rental business would be subject to the $10,000 overall SALT deduction limitation.

[2] Based on chart of average state and local tax deductions by states from 1997 to 2015, dated October 12, 2017 and prepared by the Tax Policy Center (http://www.taxpolicycenter.org/statistics/state-and-local-tax-deduction).
[3] The Governor's proposals also would create an "Employer Compensation Expense Tax" (**ECET**). Under the Act, businesses are still entitled to a full deduction for their SALT. To protect their employees from the tax increases associated with the limitations on personal SALT deductions, employers would be able to opt-in to a new ECET system. Employers that opt-in would be subject to a 5% tax on all annual payroll expenses in excess of $40,000 per employee, phased-in over three years beginning on January 1, 2019. The progressive personal income tax system would remain in place, and a new tax credit corresponding in value to the ECET would cut the personal income tax on wages and ensure that New York filers subject to the ECET would not experience a decline in take-home pay.