

Are State and Local Income and Property TAXES Akin to Charitable Contributions...An Analysis of an Inequitable Limitation...

Constance J. Crawford
Ramapo College of New Jersey

Corinne L. Crawford
Borough of Manhattan Community College

Glenn C. Vallach
Ramapo College of New Jersey

In December 2017, President Trump signed H.R. 1 into law the largest tax reform legislation since 1986. As a result of the sweeping changes, the State and Local Tax Deduction has been reduced to \$10,000.... from an UNLIMITED deduction prior to the new legislation. Unfortunately, there are certain states, where 30-40% of their taxpayers claim an average SALT deduction of \$21,000, primarily New York, New Jersey, Connecticut and California (Byerly,2018.) Does the 2017 federal tax overhaul accentuate an inequity in the Internal Revenue Code?

INTRODUCTION

Prior to the 2018 H.R.1 legislation, taxpayers were entitled to claim itemized deductions for state and local income and property taxes on their *Schedule A Itemized Deduction* tax form. That deduction was unlimited and therefore would reduce the taxpayer's federal income tax obligation. The real estate tax deduction provided an incentive for home ownership as it created a pathway for reduced federal taxes. H.R.1 changed the landscape of State and Local Tax deductibility by providing a cap on the aggregate amount of taxes allowed. From an unlimited amount, the act denies a deduction for individual, state and local taxes, with the exception of itemized deductions up to \$10,000 for all state and local taxes. Therefore, for many taxpayers in the highest taxed states, this limitation provided a punishment for both geographic locales and home ownership.

Many of the hardest hit states are attempting to find creative ways to minimize the tax deductibility of the state and local taxes. In California for example, has created a charitable entity called the California Excellence Fund in order for taxpayers to make VOLUNTARY contributions in lieu of State Taxes (Faber, 2018). The intended target...circumventing the \$10,000 State and Local Tax Limitation. This has been seen as an innovative idea....but will the IRS allow the renaming of taxes to charitable contributions?

CURRENT TAX LAW

The IRC (Internal Revenue Code) clearly delineates the deductibility of payments as charitable contributions. The IRC § 170 states that charitable contributions are ONLY DEDUCTIBLE if, per IRS rulings, the contributions “is solely for PUBLIC PURPOSES and therefore the requirement provides an obstacle for the newly interpreted state and local tax payment issue. Additionally, the Internal Revenue outlines in PUB 526, what would be a QUALIFIED deduction for a charitable contribution and states further, there can be no individual benefit to the donor.

Fundamentally, in order for a charitable contribution to qualify for a federal income tax deduction the contribution must actually be charitable; the taxpayer receiving some benefit or *quid pro quo* in exchange for the contribution cannot take the deduction up to the value of the benefit received in return (Pedersen, 2018). Interestingly, Congress has provided a deduction for state and local taxes since the first federal income tax statute in 1861 (Ahroni, Biagio, Sillman, 2018.)

IS THE SALT LIMITATION UNCONSTITUTIONAL?

Many legislative and tax experts opine that the Tax Cuts & Jobs Act’s (TCJA) \$10,000 SALT limitation is unconstitutional because it violates both the Tenth and Sixteenth Amendments to the US Constitution (Henchman, 2018.)

The Tenth Amendment was designed to prevent the federal government from limiting the sovereign rights of the states by stating the following:

“Principle of Federalism through the provision of powers not granted to the federal government nor prohibited to the individual states” (<https://taxfoundation.org/2018>.)

The Tenth Amendment has been interpreted as follows as it relates to the unconstitutional nature of the SALT limitation:

“By reserving to the states a concurrent power to tax, and thereby imposing structural limits on the federal government’s tax power, the Founders ensured that the federal government could not use its new tax power to undermine the sovereign authority of the States to determine how to make public investments and how to tax their residents to support those investment” (<https://taxfoundation.org/2018>.)

The Sixteenth Amendment provides the federal government with the authority to tax incomes and states the following:

“The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration” (<https://constitution.laws.com/sixteenth-amendment/> 2018.)

Unfortunately, Congress has an extensive history of attempting to limit the State & Local Tax deduction in spite of the alleged unconstitutional nature of said restrictions. In 1969 the Alternative Minimum Tax (AMT) was enacted which limited SALT deductibility. In 1986, SALT was restricted to include ONLY income and property taxes and therefore disallowing deductions for sales and other local taxes. Finally, in 1993 Congress enacted the Pease limitation, which once again reduced the deductibility of State & Local taxes for certain high income taxpayers (Ahroni, Biagio, Sillman, 2018.)

ARE SALT PAYMENTS AKIN TO CHARITABLE CONTRIBUTIONS?

Unfortunately, for many proponents of the new interpretation of SALT payments, the IRS will argue that taxpayers receive a plethora of benefits from their state and local taxes and therefore the characterization of said taxes as akin to a charitable donation is false (Byerly, 2018.) The IRS has issued the following guidance regarding the character of charitable contributions (Rappaport, 2018):

“Topic Number 506 - Charitable Contributions: You can only deduct charitable contributions if you itemize deductions on Schedule A.

To be deductible, you must make charitable contributions to qualified organizations. Contributions to individuals are never deductible. To determine if the organization that you contributed to qualifies as a charitable organization for income tax deduction purposes, refer to our Tax Exempt Organization Search tool. For more information, see Publication 526, Charitable Contributions and Can I Deduct My Charitable Contributions?

If you receive a benefit from the contribution such as merchandise, goods or services, including admission to a charity ball, banquet, theatrical performance, or sporting event, you can only deduct the amount that exceeds the fair market value of the benefit received.

For contributions of cash, check or other monetary gift (regardless of amount), you must maintain a record of the contribution:

- ***A bank record or a written communication from the qualified organization containing the name of the organization, the amount, and the date of the contribution.***
- ***In addition to deducting your cash contributions, you generally can deduct the fair market value of any other property you donate to qualified organizations. See Publication 561, Determining the Value of Donated Property. For any contribution of \$250 or more (including contributions of cash or property), you must obtain and keep in your records a contemporaneous written acknowledgment from the qualified organization indicating the amount of the cash and a description of any property contributed. The acknowledgment must say whether the organization provided any goods or services in exchange for the gift and, if so, must provide a description and a good faith estimate of the value of those goods or services. One document from the qualified organization may satisfy both the written communication requirement for monetary gifts and the contemporaneous written acknowledgment requirement for all contributions of \$250 or more.***

You must fill out Form 8283.pdf, Noncash Charitable Contributions, and attach it to your return, if your deduction for a noncash contribution is more than \$500. If you claim a deduction for a contribution of noncash property worth \$5,000 or less, you must fill out Form 8283, Section A. If you claim a deduction for a contribution of noncash property worth more than \$5,000, you'll need a qualified appraisal of the noncash property and must fill out Form 8283, Section B. If you claim a deduction for a contribution of noncash property worth more than \$500,000, you'll also need to attach the qualified appraisal to your return.

Special rules apply to donations of certain types of property such as automobiles, inventory and investments that have appreciated in value. For more information, refer to Publication 526, Charitable Contributions. For information on determining the value of your noncash contributions, refer to Publication 561, Determining the Value of Donated Property (IRC PUB 506).”

The IRS guidance is complex and therefore subject to interpretation by tax filers in an attempt to justify the characterization of state and local tax payments as charitable contributions (Rappaport, 2018.) The innovative characterization of SALT payments as charitable contributions has been viewed as an attempt to avoid compliance with H.R. 1 and is the subject of continuing debate. Whether this new interpretation of SALT payments is merely an attempt to find a loophole in the 2017 tax legislation is problematic and will be subjected to close scrutiny by the IRS.

IMPACT OF TAX LOOPHOLES

A tax strategy aimed at the avoidance of a tax is defined as a tax loop hole and defined as follows: “a legal way of avoiding the payment of tax, or part of a tax bill, due to a gap in tax legislation.” This process has been a popular strategy invoked by the wealthy taxpayers whenever a tax imposed by the government was viewed as a punitive tax (Schreiber, 2018.). Now, the restriction of the deduction for state and local taxes can also be viewed as a punitive action aimed at the highest tax states. Additionally, the search for tax loopholes will be expanded to include any taxpayer whose state and local income and property taxes exceed the freshly minted but arbitrary \$10,000 threshold. The goal of any tax reduction strategy cannot be seen as a path to tax avoidance rather than an allowable tax-deductible payment. The IRS has no intention of allowing state and local income and property taxes to merely be re-characterized as charitable contributions in response to the 2018 tax changes (Walczak, 2018.)

Tax loopholes are not a new innovation and the IRS has a history of closing the tax reduction loopholes viewed as noncompliance with tax law. But there has been precedence in some states that could provide a plethora of opportunity for the charitable contribution agreement. In Alabama for example, taxpayers have been allowed to deduct 100% of money donated to organizations that give vouchers to children to attend private schools (Faber, 2018.) States like New York are in the process of drafting similar legislation and the IRS would find it extremely difficult to recognize the tax status of the deduction for a resident of Alabama and not allow a similar deduction for the residents of New York (<https://ag.NY.gov/state/2018>.)

THE INEQUITY IN THE CURRENT STATE AND LOCAL PROPERTY TAX PROCESS

Most local governments in the United States impose a **property tax**, also known as a **millage rate**, as a principal source of revenue (Pedersen,2018.) This tax may be imposed on real estate or personal property. The tax is nearly always computed as the fair market value of the property times an assessment ratio times a tax rate, and is generally an obligation of the owner of the property. The tax is administered at the local government level. The tax becomes a legally enforceable obligation attaching to the property at a specific date. The services that are normally funded by property taxes include **education**, emergency services, transportation, libraries and parks, as well as different recreational activities (Pedersen,2018.) There has been some debate about whether property taxes that are IMPOSED are essentially as an exercise of privilege (Walczak, 2018).

The current property tax statutes provide no opportunity for a taxpayer to have any control over how those funds are dispersed (<https://IRS>, 2018.) Which results in an extreme inequity to a property owner compared to a non-property owner. Therefore, if a property owner had the option of **DONATING** their Property Taxes to a specific state or local service of their choice, that would provide an element of fairness to the current tax system. Furthermore, In May 2018, New York State Department of Taxation and Finance, prepared a document entitled: **Charitable Contributions to Local Governments and School Districts**, authorizing the establishment of charitable gift reserves funds in an attempt to offer real property tax credits as an incentive for contributions (<https://ag.NY.gov/state / 2018>). The funds will be characterized as unrestrictive charitable contributions earmarked for educational and other charitable endeavors (<https://ag.NY.gov/state /2018>).

The property tax **CONTRIBUTION** will result in a 95% tax credit for the taxpayer/charitable contributor. In addition, NYS has prepared tax form RP-980-a-ACC Acknowledgement of Charitable Contribution and form RP-980-a-CCF Claim for Property Tax Credit for a Charitable Contribution, that the tax filer would include with their annual tax return in support of their charitable contribution. (Pederson, 2018.) By filing these tax returns, the character of the property tax payment will be changed to a charitable contribution and therefore provide the taxpayer with a solution to the arbitrary limit imposed on SALT by the 2017 Tax Cuts and Jobs Act.

This concept is not new, many states, prior to the enactment of H.R. 1 had already established programs aimed at supporting charitable contributions for educational needs in return for the tax credit

benefit (Byerly, 2018.) Additionally, SEC 170 © (1) of the Internal revenue Code allows for a federal tax deduction for charitable contributions made to a state or possession of the United States (Pedersen, 2018.) The only restriction on the tax deductibility of the contribution is that the “gift:” be made exclusively for the benefit of the public (Walczak, 2018.)

THE INTERNAL REVENUE REACTION

The IRS is strongly opposed to any tax strategy that is essential viewed as a gimmick aimed at circumventing the intent of tax legislation (Rappaport,2018.) Furthermore, the IRS has stated that even though they may have been lax in the treatment of previously existing **charitable tax contributors**, their view of the recently designed tax avoidance strategies are different from the deductions that are currently deductible (Byerly,2018.) At the center of the discussion, is whether the charitable contribution, made by the taxpayer in lieu of their property taxes, is merely a tax payment in disguise. In May of 2018, the IRS issued a statement regarding the newly crafted state legislation in response to the SALT limitation provision of the 2018 Tax Cuts and Jobs Act (Call, Faber, McLoughlin, Yopp, 2018.) The IRS issued NOTICE 2018-54 notifying taxpayers that they are drafting a response to the state plans in order to provide guidance prior to the 2018 tax filing season (<https://IRS.charitablecontributions/2018>.)

It is apparent the IRS will be reluctant to allow taxpayers, from high state tax states, to unfairly receive tax abatement from state taxes in an attempt to circumvent the restrictions of the new tax legislation. Furthermore, it is apparent that the IRS will challenge the states attempts to override the provisions of the 2018 tax legislation. Additionally, the IRS stated they would not tolerate states that try to “*flout the law*”---clearly a position that will be challenged in court for years to come (Rappaport & Tankersley, 2018).

CONCLUSION

The Internal Revenue Code, has long been viewed, as a complex set of subjective rules and filing requirements that provide a plethora loopholes for the wealthy and an inequity for the beleaguered middle class. H.R. 1 has only added a new layer of complexity and ambiguity to the regulatory guidelines. If the goal of the legislation was to provide a more equitable tax process, clearly taxpayers living in New York, California and New Jersey, to name a few, are not in agreement. Additionally, The Tax Cuts and Jobs Act, has only widened the chasm between the taxpayer and the federal government. Whenever legislation is viewed as punitive, the reaction will be defensive. Therefore, the plan to circumvent the unfair limitation on the deduction of State and Local Income and Property Taxes to \$10,000 from a prior UNLIMITED amount could be the only expected outcome of such an arbitrary decision by the federal government.

REFERENCES

- Byerly, V. (2018). Are Proposals by States to Recast SALT Payments as Charitable Contributions a Valid End-Run Around the New \$10,000 Limitation? *Tax Technology Resources*.
- Call, R., Faber, P., McLaughlin, A., & Yopp, M. (2018). New York's Response to Federal Tax Reform: Charitable Contribution Credit, *NYSSCPA*.
- Davis, C. (2018). Salt/Charitable Workaround Credits Requires a Broad Fix. *Not a Narrow One*. Retrieved from <https://itep.org/salt-charitable-workaround-credits-require-a-broad-fix-not-a-narrow-one/>
- Faber, P. (2018). Charitable Funds and the Disallowance of Federal Income Tax Deductions for State and Local Taxes. *AICPA*.
- Grossman, B. (2018). *IRS Aims to Limit Charitable Contributions Made to Avoid SALT Deduction Limit*. Retrieved from <https://gyf.com/irs-aims-to-limit-charitable-contributions-made-to-avoid-salt-deduction-limit/>
- Henchman-Bishop, J. (2018). Evaluating the SALT Deduction Constitutional Challenge. *Tax Foundation*. Retrieved from <https://taxfoundation.org/salt-deduction-constitutional-challenge/>
- Holland, L. (2018). *US District Court for the Southern Division*. Retrieved from https://ag.ny.gov/sites/default/files/salt_complaint_as_filed_with_exhibits.pdf
- Murphy, P. (2018). Retrieved from <https://www.nj.gov/state/archives/pdf/amendments.pdf>
- Pedersen, Cynthia (2018). Workarounds to the State and Local Tax Deduction Limitation. *The Tax Adviser, AICPA*.
- Rappaport, A., & Tankersley. (2018). IRS Warn States Not to Circumvent State and Local Tax Cap. *The Tax Adviser*.
- SALT Update- New Jersey Releases Implementation Rules for SALT Charitable Contribution Law. (2018). Retrieved from <https://njmma.org/articles/salt-update-new-jersey-releases-implementation-rules-salt-charitable-contribution-law>
- Schreiber, S. (2018). IRS to Clarify Rules on Payments in Lieu of SALT. *Journal of Accountancy*.
- United States Constitution (2018). Retrieved from <https://constitution.laws.com/sixteenth-amendment-to-the-united-states-constitution>
- Walczak, J. (2018). State Strategies to Preserve SALT Deductions for High-Income Taxpayers; Will They Work? *Tax Foundation*.