State Tax Observations

How Will States React to the Federal Tax Reform?

By Sandy Weinberg, JD, Principal

Blue states and their residents are feeling blue in light of the federal Tax Cuts and Jobs Act. The main culprit is the new limit on the deduction for state and local taxes (SALT). The cap on the SALT deduction will lead to a greater increase in federal personal income taxes in blue states such as California, New York, New Jersey, Connecticut, Maryland, Massachusetts and Illinois than in red states because, on average, blue states have higher state income tax rates. But blue states are creatively contemplating ways around the federal tax law changes. The results promise to be interesting.

So, how will the states counteract the effect of the cap on the SALT deductions? We layout in this newsletter some methods being considered.

States Can Sue the Feds

The easiest way to contest the tax changes is to sue the federal government. New York has announced that it is doing just that. The basis of the lawsuit is that the new tax law limits on SALT (income and property tax) deductions to a maximum of $10,000 which will effectively raise property and income taxes for New Yorkers by 20%. According to New York Governor Andrew Cuomo, the federal tax reform "is illegal, and we will challenge it in court as unconstitutional … violative of states' rights and the principle of equal protection." Nevertheless, it is doubtful that the federal courts will seriously entertain striking down the new law's cap on the deduction. The federal government has a rationale that the law change simply eliminated an unfair benefit.

What About Reclassifying SALT Payments as Charitable Gifts?

Charitable donations are still deductible under the new federal law. California, among other states, is considering a workaround by treating the payment of California personal income taxes as voluntary "gifts" to the state that would be deductible as charitable donations. New Jersey's governor-elect Phil Murphy stated he is working on a plan that would effectively convert property taxes into charitable gifts. However, the IRS is aware of all types of reclassifications and could easily attempt to disallow the reclassifications. It would not be surprising to see the IRS succeed.

Repealing State Income Taxes and Replacing Them with Payroll Taxes

Perhaps the most promising option for blue states is to eliminate (or reduce) their personal income taxes and instead institute employer-paid payroll taxes in an equivalent amount. Payroll taxes imposed on businesses are still deductible under the new federal law. Instantly, the federal change would be counteracted, at least as concerns state income taxes. The federal treasury would take an enormous hit. But economically, blue state taxpayers would end up in the same place as if they could deduct their income taxes. New York is considering this option.

An unintended benefit of implementing the employer-paid payroll tax is that payroll taxes are collected by businesses, not individuals, which vastly simplifies tax preparation for average individuals and families.

However, one wrinkle is that payroll taxes only affect payroll. Other classes of income like capital gains, interest, and dividends aren't impacted by payroll taxes. Further, the law change would be complex and difficult to implement.

One other caveat is that employees' gross wages would be less since the tax burden is picked up by the employer. To the employee it might seem as though he or she is taking a salary cut, even though the net wages are the same.

Decoupling

In certain situations, states may wish to increase (or decrease) their tax revenue. In order to do so, with respect to the Tax Cuts and Jobs Act, a state may simply decouple, if permitted (or enact legislation to decouple if not generally permitted) from the following new provisions:

- IRC Sec. 168 cost recovery
- IRC Sec. 163(j) provisions regarding interest expense limitations
- IRC Sec. 965 repatriation "toll tax"
- IRC Sec. 245A international tax "territorial system"

A Last Resort?

If all else fails, residents in blue states could uproot their lives and businesses and move to lower tax or no tax jurisdictions such as Florida, Texas or Nevada. But that is never easy to do, and to add salt (pun intended) to the wound, the moving expense deduction also was eliminated by the new federal law.

Let's see how things play out.

Contact Us

If you have questions regarding how states are reacting to the federal Tax Cuts and Jobs Act or if you have state tax questions generally, contact Sandy Weinberg at sweinberg@pkfod.com.