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IRS may nix blue states' workaround on tax deduction caps

- The new tax law caps the deduction for state and local income taxes at $10,000.
- Legislators in New Jersey, New York and Connecticut have recently passed "workarounds" to allow homeowners to contribute to local charitable funds and get a federal deduction.
- Whether this passes muster with Treasury and the IRS remains to be seen.

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A number of high-tax states have recently passed legislation to help residents manage new caps on their ability to take federal tax deductions.

However, accountants are warning taxpayers to proceed with caution.

This year, the Tax Cuts and Jobs Act put in place a $10,000 cap on the amount of state and local taxes (SALT) that filers can claim on their taxes.

Residents in high-tax locales can expect to feel the pain: In 2015, the average New Yorker's SALT deduction was $22,169, according to the Tax Policy Center. In New Jersey and Connecticut, those amounts were $17,850 and $19,665, respectively.

In response to the new tax code, those three states passed laws to create a workaround: Municipalities will be permitted to establish charitable funds to pay for local services and offer property tax credits to incentivize homeowners to make contributions.

New York's Gov. Andrew Cuomo signed off on this legislation on April 17. New York has also enacted a new voluntary payroll tax to address workers' inability to to exceed the cap on their income taxes.

On May 4, New Jersey Gov. Phil Murphy signed legislation to permit cities and towns in the Garden State to move forward on the charitable fund strategy.

And Connecticut lawmakers approved the state's bill for a similar measure on May 9. The measure awaits the signature of Gov. Dannel P. Malloy.

Tax filers who itemize on their taxes are also able to claim a charitable tax deduction on their federal taxes — and can do so above and beyond the $10,000 SALT cap.

What's unknown is whether the IRS will bless these workarounds. Treasury Secretary Steve Mnuchin has already signaled his disapproval.

"I hope that the states are more focused on cutting their budgets and giving tax cuts to their people in their states than they are in trying to evade the law," he said at a press briefing in January.

Here's what these developments mean for your taxes.

Conservative approaches

Even though state legislators have given their blessing — and have signaled that they're willing to fight the federal government in court — tax lawyers are telling their clients to hold off on making contributions to municipalities' charitable funds for now.

"I think for everybody that we've dealt with in the states with the workarounds, we've expressed our concern that Treasury may not go along with this," said Michael D'Addio, a principal with Marcum LLP.

Attorneys and critics of the workarounds said that the IRS requires that there be charitable intent in order for a contribution to be deductible.

Municipalities' decision to offer donors a credit for donating to a charitable fund may also be seen as fishy, critics and lawyers said.

"Also, if you make a contribution that imposes a liability on the recipient, then the liability disallows the contribution," said Jared Walczak, senior policy analyst at the Tax Foundation.

"In this case, the liability is the local or state government offering a tax credit, which zeroes out the actual charity," he said.

New York payroll tax

The opt-in payroll tax would work like this: Employers would reduce their workers' base salaries and then lower the workers' state income taxes through the new payroll levy.

The payroll tax, which will take effect on Jan. 1, 2019, would start at 1.5 percent and apply to workers' wages exceeding $40,000 a year.

Whether employers will take to this new payroll tax remains to be seen. Companies have a lot to consider.

"It takes planning on the part of the employer and a lot of communication with the employees to understand that they're being held harmless," said Brian Galle, a professor at Georgetown Law. "Employers will want to start thinking about that now."

The IRS hasn't indicated whether it will allow the workaround to proceed.

Risk and reward

For individuals who are questioning whether to make a contribution to their municipality's charitable fund instead of paying the property tax as they usually do, attorneys are advising them to sit tight for now.

"The caveat we give clients is that it remains to be seen from the IRS's point of view," said Seth Rabe, senior manager of the state and local tax services group at Mazars USA. "You could potentially be subject to back taxes and your contribution isn't viewed as a gift."

To play it safe, filers could always try maxing out the available $10,000 SALT deduction prior to making charitable contributions to state funds, Walczak said.

Waiting until the absolute last minute for guidance might also be smart.

"Hopefully, we'll know in December whether to make the charitable contributions," Galle said. "You'd want to wait until the end of the year to see what the federal government will say about the federal deductibility of these things."