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New York, Connecticut Taxpayers Have Plan B Options to Beat SALT

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- Connecticut approved workaround for pass-through businesses
- New York employers have until December to elect payroll tax

Taxpayers in New York and Connecticut still have a few potential options to avoid the hit from a new cap on state and local tax deductions, while residents of other high-tax jurisdictions may only have creative estate planning as a last resort.

The Internal Revenue Service focused its proposed regulations last week on blocking the charitable programs approved by some high-tax states to skirt the $10,000 federal limit on so-called SALT deductions. It remained silent on other workarounds some states have in place to get around the cap.

The most popular mechanism to avoid the limit had been to allow taxpayers to make "charitable contributions" for their property tax payments, which would then have been eligible for a full federal tax write-off.

But New York and Connecticut included some Plan B options in their legislation to ease the potential tax hike for residents. Connecticut allows owners of so-called pass-through businesses -- such as partnerships, limited liability companies and S corporations -- to take bigger federal deductions to absorb some of the SALT hit. New York created a way for employers to shield their employees from the deduction cap. And tax advisers say a series of complex transactions involving trusts could effectively get around the $10,000 limit.

Read about how IRS set its proposed regulations to take effect after Aug. 27

The back-up plans are still risky -- each with their downsides -- and it's possible the IRS could ultimately block them, too. For some taxpayers, though, the tax pain is too great not to at least try.

Steve Rossman, a shareholder at accounting firm Drucker & Scaccetti in Philadelphia, said some taxpayers are still keen to minimize their liabilities, and are interested in other options, even if they require some additional work.

"People will try everything that's within the boundaries of the law, versus losing a huge state tax deduction," Rossman said.

The cap will increase New Yorkers' federal taxes by $14.3 billion in 2018, and an additional $121 billion from 2019 to 2025, according to an analysis by the New York State Department of Taxation and Finance. Connecticut taxpayers will see an additional $2.8 billion federal income tax liability as a result of the SALT cap in 2018, the state's estimates show.

Connecticut Pass-Through Tax

Connecticut Governor Dannel Malloy signed legislation in May that sets a 6.99 percent levy -- the state's top marginal individual income tax rate -- on pass-through entities, which report their income on owners' personal returns.

Pass-through owners then get a credit equal to 93 percent of the owner's share of tax paid by the business. The strategy effectively lets pass-through owners take bigger federal write-offs to help offset their previously unlimited SALT deductions.

For example, if a Connecticut partnership has two partners and $1 million in income in total, it would pay the state $69,000 under the new pass-through entity tax. That would leave $931,000 of taxable income to pass along to the two partners. The two partners could deduct 93 percent of that $69,000, or $32,085 each, from their federal tax bills -- an offset that could compensate for the SALT cap.

Still, some tax professionals aren't sure the state's plan, which took effect on Jan. 1, will work.

Depending on how much income your pass-through makes, the workaround "might not cover your SALT bill," said John Ermer, an accountant and tax partner at Beers, Hamerman, Cohen & Burger in New Haven, Connecticut.

If the IRS were to issue regulations striking down these types of arrangements, or the arrangements were challenged in an audit, taxpayers could be in a position where they pay the state more than their tax bill was in the first place, said Michael D'Addio, a principal at accounting firm Marcum.

New York Payroll Tax

New York state also included a way to mitigate the SALT issue through employers in its legislation about the charitable workarounds. Since the tax law kept businesses' SALT deductions unlimited, the New York law lets companies opt in and essentially pay for their employees' state taxes.

The payroll tax would partially replace the personal income tax and be deductible for employers. To cover the state tax payments, companies may lower wages, which is seen as a major hurdle to the strategy becoming popular. But it's possible more companies will consider the workaround

after the IRS moved to curb the charitable contribution programs. They have until Dec. 1 to opt in for 2019.

The New York State Department of Taxation and Finance issued guidance in July with more details for employers. Critics said the guidance still didn't answer the question about whether employers could be prohibited from adjusting wages to offset the cost of the tax.

The payroll workaround is administratively difficult and won't benefit very many people, according to Jared Walczak, a senior policy analyst at the Tax Foundation. Companies will have to make sure their payments comply with collective bargaining agreements and state minimum wage laws.

The state's department of taxation and finance didn't respond to an inquiry about how many companies have signed up for the program.

Non-Grantor Trusts

There may be one other option for wealthy individuals, regardless of where they live, to try to avoid the $10,000 SALT limit. The move generally involves a series of transactions to put residences into a limited liability company in no-tax states, and then transferring those interests into separate trusts that can each take the $10,000 deduction.

While trusts are generally used by the richest Americans, non-grantor trusts for property tax deductions may make the most sense for the merely well-off who have property taxes totaling as much as $100,000, tax experts say.

Setting up dozens of non-grantor trusts for those with six-figure plus property taxes can be impractical and burdensome. Plus, those whose taxes are under six figures feel the new cap most acutely.

Like the other options, the IRS could issue guidance that would prevent taxpayers from using the trusts to get around the SALT cap. An existing provision says that multiple non-grantor trusts with identical beneficiaries and identical grantors -- and whose primary purpose is to avoid taxes -- can potentially be considered a single entity, with just one $10,000 SALT deduction. But the measure has never been bolstered by regulations, leaving it vague.

Tax advisers also caution that taxpayers have to take into account the costs -- which could be around $20,000 -- associated with setting up and administering such trusts.

Ultimately, the strategy makes the most sense as part of estate planning, as opposed to a standalone tax move since the current property owner can't end up as the sole beneficiary of the trust, according to Geoff Weinstein, special counsel at law firm Cole Schotz.

"It wouldn't be the sort of transaction you would be doing if estate planning weren't part of the analysis," Weinstein said.