Blanche Lark Christerson
Managing Director,
Senior Wealth Strategist

Tax Topics

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One month later: “SALT” and The Tax Cuts and Jobs Act

It has been over a month since President Trump signed into law The Tax Cuts and Jobs Act (Pub. L. 115-97), the informal name of this sweeping new tax legislation. Businesses were key beneficiaries of the Act, but individuals benefitted as well, and will see, for example, reduced income tax rates from 2018 through 2025. In part, the Act helped pay for these changes by reducing (or eliminating) a number of deductions for individuals. Specifically, the new $10,000 cap on an individual’s deduction for state and local taxes, what’s known as “SALT,” is a case in point…and a big deal for very high-income taxpayers in high-tax states, such as New York, New Jersey, Connecticut and California.

That is, prior to the Act, taxpayers who itemized their deductions (rather than using the “standard” deduction) generally had an unlimited deduction for state and local income taxes (or sales tax, if elected instead), real property taxes and various other local taxes – *provided that* they were not subject to the alternative minimum tax (AMT), a parallel tax system that requires taxpayers to figure their taxes twice – the “regular” way and the AMT way (taxpayers pay whichever amount is higher). The AMT disallows the SALT deduction (along with other tax benefits that reduce a taxpayer’s regular income tax) by treating it as “alternative minimum taxable income.” Put simply, SALT dollars are taxable under the AMT.

Also, the so-called “Pease limitation,” which the Act eliminated, meant that most itemized deductions (including SALT, mortgage interest and charitable contributions) were subject to what was generally a 3% “haircut” if the taxpayer had “too much” income.

Thus, prior to the Act (and Pease notwithstanding), taxpayers who paid “enough” regular tax to be outside the AMT could save significant federal tax dollars with their SALT deduction, which could run to the tens of thousands of dollars. The new $10,000 cap on SALT (or $5,000, for married taxpayers filing separately) essentially means that these taxpayers have no SALT deduction, and are therefore likely to owe more federal tax, an issue the Act’s new lower tax rates may help mitigate.

And therein lies a serious problem for high-tax states. The state and local tax dollars of very wealthy individuals represent a significant source of state and local revenues. If these individuals decide they've had enough and relocate, say, to Florida, which has no income tax, their lost tax dollars will leave a budget hole, and could require corresponding cuts to state and local services. It's not a pretty picture.

End-of-year workarounds. In the waning days of 2017, taxpayers who were mindful of the pending SALT cap were rushing to prepay their 2018 real property taxes, as the Act didn't address this – unlike its specific prohibition on prepayments of 2018 income tax liabilities. In response, the IRS issued IR-2017-210 on December 27, 2017. The notice explained that 2017 prepayments of 2018 real property taxes would be deductible in 2017 IF those 2018 taxes had already been "assessed" – something that is determined by state or local law; if the taxes hadn't yet been assessed, then the prepayment would not be deductible in 2017. In other words, depending on the facts and circumstances, taxpayers who prepaid their 2018 real property taxes may or may not be able to deduct these payments in 2017.

State responses. What are high-tax states doing about the new SALT limitation? Litigation is likely, as are possible changes to a state's income tax structure.

In terms of litigation, New York, New Jersey and Connecticut are reportedly organizing a multi-state coalition to challenge the SALT limitation in federal court, on the grounds that the cap unconstitutionally imposes double taxation on state residents and infringes upon states' rights.

Double taxation. How solid is this constitutional argument? Perhaps that depends on which piece of the SALT deduction is at issue. For example, if taxpayers are subject to federal AND state and local taxes on their income, then that appears to be double taxation. Yet the same issue has existed for years with respect to taxpayers who are subject to the AMT: they are precluded from taking the SALT deduction, which is considered taxable income in the AMT calculation (see above). As to the part of SALT that represents real property taxes, and, say, local school taxes, there is no comparable federal tax; how, then, is there double taxation? The point is that a legal challenge from affected states is apparently coming, but success may prove elusive – and litigation is an arduous and expensive process.

Structural changes. What about structural changes to a state's income tax? Treasury Secretary Mnuchin has already warned that attempts to circumvent the new SALT limitation will be scrutinized, and will trigger audits for residents of states pursuing this approach.

Undaunted, New York seems to be leading the charge. The New York State Department of Taxation and Finance recently released a 33-page report entitled "Preliminary Report on the Federal Tax Cuts and Jobs Act." The Report's introduction states that the new federal law will have a "disproportionate" impact on New York's economy and tax system; it notes that New York is a "donor" state that sends $48 billion more to the federal government each year than it receives back in federal dollars, and that the new law appears to target donor states that "must raise state and local taxes to make up for this deficit in federal financial support for critical programs and services."

The Report mentions various ways to possibly restructure New York's income tax system, including payroll taxes on employers that might be in lieu of a personal income tax on wages (such a tax would be deductible by employers, and presumably would result in employers reducing employees' wages to produce economic parity), or creating State-operated charitable funds to which taxpayers could contribute in exchange for tax credits that could be applied against their New York taxes. The Report acknowledges that extensive analysis is required to determine the best response to the Act, and that any changes to New York's tax law will be the result of "an intensive and measured process."

The bottom line? It will be interesting to see if wealthy taxpayers in high-tax states vote with their feet – and how these states respond to the SALT limitation. Although it is small consolation, taxpayers who were previously subject to the AMT because of, say, a large SALT deduction, may now be outside of the AMT, for which there are higher exemptions and phase-out levels for that exemption.

…and speaking of New York…

529 accounts. The Report mentioned above notes that the Act now permits up to a $10,000 per year distribution from a 529 account for a beneficiary's K – 12 tuition at a public, private or religious school. (Prior to the Act, 529s were solely designed to offer tax-preferred savings for a beneficiary's "qualified higher education expenses," a broad term that includes tuition, room and board, and various other expenses related to college, graduate or vocational school.) The Report states that "it appears" that distributions for K – 12 tuition from a New York 529 account would not be "qualified distributions" for New York purposes and could trigger a recapture of any tax benefits that had accrued on contributions (for example, New York permits up to a $10,000 above-the-line deduction for married couples contributing to a New York 529 account). The Report states that "We will continue to review the federal law's provisions on 529 plans on New York residents, and welcome discussion for possible solutions and alternatives."

> **Comment.** Although New York law follows the federal definition of a "qualified higher education expense," the issue appears to arise with New York's definition of a "qualified withdrawal," which requires that a withdrawal be for a qualified higher education expense at an "eligible educational institution" – i.e., an institution of higher education. Until there is clarification on this matter, a distribution for K – 12 tuition from a New York 529 plan may trigger unwelcome tax results for the account's contributor.

Special New York tax on "carried interest"? "Carried interest" typically refers to the profits interest of those who manage hedge funds and private equity funds. Prior to the Act, if such an interest was held for more than a year, it was eligible for capital gains tax treatment (the maximum rate for long-term capital gain is 20%, versus the new top individual income tax rate of 37% – keeping in mind that there is also the 3.8% tax on net investment income). The Act now requires that such interests be held for three years to qualify for capital gains tax treatment. New York's Gov. Andrew Cuomo has recently stated that the carried interest "loophole" costs New York about $100 million every year. Accordingly, he has proposed a 17% "fairness fee" on carried interest, and that this interest be treated as a business receipt for services, and as income attributable to a trade or business. This proposal would not take effect, however, unless Connecticut, New Jersey, Massachusetts and Pennsylvania implemented similar legislation.

> **Comment.** Considering the very real concern in New York (and other high-tax states) about high-income taxpayers decamping because of the SALT limitation, an additional tax on some of these very same taxpayers might be ill-advised. Query whether Connecticut, New Jersey, Massachusetts and Pennsylvania decide the risk is worth it.

New York's estate tax exclusion amount. When New York modernized its estate tax law in early 2014, one of the goals was to gradually increase its $1 million estate tax exclusion (currently $5.25 million), so that by 2019, it would match the federal estate tax exclusion ($5 million, indexed for inflation). In 2017, the federal exclusion was $5.49 million, or $10.98 million per married couple. Prior to the Act, the federal exclusion was scheduled to rise to $5.6 million in 2018, or $11.2 million per married couple. From 2018 through 2025, however, the Act doubles the $5 million federal exclusion to $10 million, indexed for inflation, using a new “chained” consumer price index (CPI), rather than the traditional CPI measure that had previously been used. (The chained CPI will produce smaller increases than the “old” CPI.) Thus, the official 2018 federal exclusion amount is as yet unknown, although it is believed to be $11+ million, or $22+ million per married couple (yes, a “use it or lose it” proposition, given the temporary nature of this increase).

The question is whether, come 2019, New York’s exclusion will automatically match this federal increase, given the goal of the 2014 legislation. Barring a legislative change, the answer appears to be no, since New York’s stand-alone estate tax is not specifically boot-strapped to the federal exclusion. As of 2019, then, New York’s exclusion is based on its own $5 million amount, indexed for inflation, using the same CPI parameters as the “old” $5 million federal exclusion.

Is New York likely to match the enhanced federal exclusion? That seems doubtful, given New York’s budget deficit. Furthermore, bear in mind that New York’s exclusion disappears entirely if a decedent’s *taxable* estate exceeds the exclusion amount by 5% or more. To illustrate, if widowed Dad, who has made no taxable lifetime gifts, dies in 2018 and leaves his $5.25 million estate to Daughter (a “taxable” estate), his estate will owe no New York estate tax; if instead, his estate is 5% bigger at $5,512,500 (an additional $262,500) and he leaves it to Daughter, his estate will owe $452,300 in New York estate tax. The tax on this “stub” amount equates to 172% (it’s “only” 8.2%, however, if viewed as applying to the *entire* taxable estate, which it does). Considering this existing structure, and the New York legislators’ conscious decision to eliminate the New York exclusion if a decedent’s taxable estate is “too big,” it’s hard to imagine New York providing an even larger exclusion. Heck, getting rid of that 5% cliff would be a welcome development!

February 7520 rate

The February 2018 7520 rate is 2.8%, an increase of 0.20% (20 basis points) from the January 2018 7520 rate of 2.6%. The February mid-term applicable federal rates (AFRs) are also up: 2.31% (annual), 2.30% (semiannual), and 2.29% (quarterly and monthly). The January mid-term AFRs were: 2.18% (annual), 2.17% (semiannual), and 2.16% (quarterly and monthly).

Blanche Lark Christerson is a managing director at Deutsche Bank Wealth Management in New York City, and can be reached at blanche.christerson@db.com.