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Potential SALT deduction cap workaround?

As part of the federal tax reform bill passed at the end of 2017, individual taxpayers became subject to a $10,000 cap on itemized deductions for state and local income, sales and property taxes (SALT deduction). Prior to tax reform, SALT deductions were not subject to a dollar cap, but were limited instead by the Alternative Minimum Tax, which effectively allowed taxpayers to take SALT deductions far in excess of $10,000. In early April, New York became the first state to create a SALT deduction cap workaround, with two potential options that would continue to allow for the deduction of SALT taxes in excess of the $10,000 cap.

Option One — Convert state income taxes into charitable contributions to state operated charitable trusts:

- Payments would be fully deductible for federal income tax purposes.
- 85-95% creditable against a taxpayer's state income taxes.
- Plan is likely to be challenged by IRS on the basis that contributions are not truly charitable in nature, and therefore not deductible.

Option Two — Convert state income taxes paid by employees into a payroll tax paid by employers:

- Would require participation from both taxpayers and employers where electing companies would pay a 5% payroll tax for all employees earning over $40k/year, which could then be credited against individual state income taxes on wages.
- This option has stronger legal footing according to legal observers, but would likely result in serious logistical HR/payroll complexities for electing companies.
- Due to appearance of lower pre-tax wages and logistical challenges, those that are most likely to take advantage of this option are small companies with highly compensated employees.

Key Takeaways

- New York is the first state to enact workaround plans for the SALT deduction cap and will be a test case to see if such plans can survive challenges from the IRS and lead to other states enacting similar plans.
- The payroll tax option is believed to have a stronger legal basis, but given the administrative complexity of such a plan, may be limited in attractiveness to smaller

employers with a greater proportion of highly compensated employees (e.g., investment funds).

- While the charitable trust option does not directly affect companies, it could affect highly compensated individuals in high tax states, such as executive management teams and investors.

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J.P. Morgan Corporate & Investment Bank Marketing, 4 New York Plaza, Floor 12, NY1-E035, New York, NY, 10004-2413, United States.

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