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Not Too SALT-y: The Disparate Federal Income Tax Treatment of Business and Non-Business State and Local Taxes

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Abstract

The Tax Cuts and Jobs Act, H.R. 1, would eliminate the federal income tax deduction for nonbusiness state and local taxes while maintaining the deduction for business state and local taxes. That disparate treatment has generated a storm of negative commentary. In this short essay, I consider whether the federal tax law should allow a deduction for business state and local taxes assuming that there is no deduction for nonbusiness state and local taxes. I argue that investors and businesses, including pass-through businesses, should be allowed to deduct state and local property and sales taxes, but not general income taxes.

Introduction: Taking the SALT Deduction with a Grain of Salt

On November 2, 2017, the House Republicans released H.R. 1 – The Tax Cut and Jobs Act.[1] The Act, which proposes major changes in the federal income tax, would reduce total tax revenue by more than $1.5 trillion over 10 years. However, many provisions in H.R. 1 would raise tax revenue. One of the most controversial of these revenue-raising provisions would limit deductions for state and local tax (SALT) payments. Under current law, SALT payments are deductible from federal income.[2] H.R. 1 would limit individuals' state and local property tax deduction to $10,000 a year, and it would not allow individuals any deduction for other SALT payments. Those changes were controversial enough. However, H.R. 1 would continue to allow taxpayers who operate a trade or business or invest to deduct SALT payments incurred in their trade or business or in the production of income. In other words, under H.R. 1, investors and business owners would keep their SALT deduction. Thus, individual owners of pass-through entities, such as partnerships, LLCs, and S corps, could deduct their business SALT

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[1] Tax Cuts and Jobs Act, H.R. 1, 115th Cong. 1st Sess. (2017).

[2] 26 U.S.C. § 164. However, sales taxes are generally deductible only in lieu of income taxes. 26 U.S.C. § 164(b)(5).

payments. Accordingly, whereas the owners of closely held businesses and investors would continue to take the SALT deduction, ordinary taxpayers would be denied the deduction.

The more favorable treatment of business owners and investors was not immediately apparent, even to sophisticated observers. The difference only became widely known when it was described in blog posts by NYU Law Professors David Kamin and Daniel Shaviro.[3] In their posts, and the coverage those posts generated, the disparate treatment of business and nonbusiness SALT payments has been variously characterized as unclear and confusing, a drafting error in need of correction, an unfair tax policy, or as a cynical and stealthy giveaway to the wealthiest.

In contrast with H.R. 1, the Senate Bill would eliminate the SALT deduction entirely. Thus, under the Senate bill, neither business nor non-business SALT payments would be deductible. In this short essay, I consider the tax treatment of individual's business SALT payments assuming that individual's non-business SALT payments are not deductible. I argue that a more favorable treatment of business SALT payments than non-business SALT payments can be an appropriate tax policy for some taxes and under certain circumstances. Specifically, I argue that business property, sales and wage taxes should be deductible, but business general income taxes should not be available. Thus, assuming the elimination of the SALT deduction for nonbusiness taxes, business SALT payments should be treated more favorably than the Senate bill, but more favorably than the House bill.

The debate over the SALT deduction has a long history – and there is no consensus on the correct federal income tax treatment of SALT payments. There are good arguments for making SALT payments deductible, not deductible, or partially deductible.[4] One argument commonly made against the SALT deduction is that SALT payments are used to provide residents with services that if purchased directly would not be deductible. This argument is made about SALT payments generally, but most frequently with respect to real property taxes, the proceeds of which are often used to provide residents with services, such as schools, fire and police protection, trash collection and parks. The claim is that if the government did not provide these services, taxpayers would otherwise purchase these services themselves with after-tax dollars. In such circumstances, it would be a reasonable policy (albeit not the only possible reasonable policy) for the federal tax law to deny a home owner who lived in her own house (an owner-occupier) a deduction for her property taxes. Given that policy, how then should federal tax law treat the property taxes paid by an owner of a rental unit? That is to say, should the owner of a residential dwelling unit who rents that unit to a paying tenant be able to deduct her property tax payments, assuming that the federal tax law would deny her that deduction if she lived in the unit himself? The next section addresses that question.

<u>Eating One's SALT: Real Property Taxes</u>

To make the example concrete, consider the following simple example. Assume units in a condominium rent for $12,500 annually and that the annual property tax payment, which is paid by the

[3] David Kamin, Is There A Gaping Hole for the Best Off in the House Bill's Limitation on the Deduction for State and Local Income Taxes? Available on Medium (November 5, 2017); Daniel Shaviro, Amazing Audacity, Start Making Sense (November 5, 2017).

[4] See Daniel Hemel, Easy on the SALT: A Qualified Defense of the Deduction for State and Local Taxes, available on ssrn (October 28, 2017).

owner—the landlord in the case of a rental unit—is $2,500. Thus, the tenant pays $12,500 in rent, out of which the landlord pays $2500 in property tax, leaving the landlord with an after-tax profit of $10,000. (I assume no other costs to the landlord in order to focus on the property taxes.) If the owner can deduct her property tax payments, she reports $10,000 taxable income; if not, she reports $12,500.

I would submit $10,000 is a better measure of her federal before-tax income than is $12,500. Her economic income is $10,000, not $12,500, as she has $10,000 to spend on herself before paying her federal taxes. In effect, she is a conduit for the payment of the property tax by her tenant, and allowing her to deduct her property tax payment on her rental property recognizes that situation. Alternatively, if the federal tax law were to deny the landlord the deduction, she would in effect be taxed on the $2500 she collects from the tenant and passes onto the tax collector. That is, the federal government would tax her on $2500 more than her income.

Moreover, the federal income tax law has already denied the deduction once. In effect, the tenant paid the property tax when he paid his rent. Of the $12,500 he paid to the landlord, $2500 was indirectly a payment of property tax. And that payment was not deductible by the tenant because rental payments on residences are not deductible.

Furthermore, harmonizing the treatment of the owner-occupier and the owner-landlord would discourage investment in rental residential real estate. The landlord would be better off investing in a project other than real estate that pays an annual return of $10,000, all of which is taxable, rather than owning rental real estate, which yields $10,000 before taxes, but exposes the landlord to tax on $12,500 income. The owner-occupier would enjoy a tax advantage (in addition to the non-taxation of imputed service income) over the investor because landlords would pay tax on the full rent they receive, but could not deduct the property taxes they pay.

It might seem that the owner-occupier and the owner-renter are similarly situated and should be taxed the same, but there are important tax differences that suggest otherwise. The owner-occupier spends $2500 in real property taxes in order to consume $12,500 of non-taxable services.[5] In contrast, the owner-landlord incurs $2500 in real property taxes in order to generate $12,500 taxable income. As a general rule, expenditures are not deductible when they produce consumption, but are deductible when they produce taxable income. The disparate treatment of owner-occupiers and owner-landlords is consistent with this general rule. The owner-occupier is denied a deduction because his expenditure generates consumption. In contrast, the owner-landlord should receive a deduction because her expenditure generates taxable income.[6]

The above principle is not limited to real estate taxes. It should apply with equal force to personal property taxes, admittedly a small class of taxes. The principle should also apply to sales taxes, a much larger class. The federal tax law has at times denied individuals a deduction for sales taxes on the grounds that these expenditures are part of the cost of consuming taxable goods and services.[7]

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[5] The imputed income from the ownership and use of long-lived capital assets, such as with owner-occupied homes, are exempt from federal taxable income.

[6] If the tax law imputed $12,500 income to the owner-occupier, then it would be appropriate for the owner-occupier to take the deduction.

[7] The Tax Reform Act of 1986 eliminated the deduction for sales taxes. Since 2004, sales taxes have been allowed only in lieu of income taxes. 26 U.S.C. § 164(b)(5).

Even so, businesses should be able to deduct the sales taxes they pay. For example, the sales taxes a car dealer pays on the office furniture it purchases is part of the dealer's cost of operating the dealership. Moreover, if the dealer were not allowed a deduction for the sales taxes she pays, then presumably she should be required to include in income the sales taxes she collects, but she should not be allowed a deduction for the sale taxes she remits.

The SALT Mines: Wage Taxes

It is worth contrasting property and sales taxes with wage taxes, another common SALT, which are typically assessed on employees. Louis Kaplow has pointed out that if under federal law employers, but not by employees, can deduct wage taxes, the taxing government can undercut the impact of the federal law by making the wage tax payable by the employer, rather than the employee.[8] For example, assume a state initially imposes a 20 percent wage tax on employees. (We ignore the self-employed for now.) An employee who earns $125,000 a year will pay an annual wage tax of $25,000. If SALT payments are generally deductible, the taxpayer will pay federal tax on $100,000. Assuming, however, that the wage tax payment is not deductible, the employee will pay federal income tax on $125,000. In that case, the state can undercut the federal government's attempt to take away its residents' deduction by shifting the tax to the employer.

By imposing a 25 percent tax on wages paid in place of a 20 percent tax on wages received, the government can shift the obligation to pay the tax from employee to employer.[9] Federal taxes aside, nothing has changed if the nominal salary drops from $125,000 to $100,000. The employee still receives $100,000 after the $25,000 wage tax payment, and the employer still incurs total compensation cost, including wage tax payments of $25,000, of $125,000. The advantage is that the SALT payment is now deductible for federal tax purposes. Thus, a federal tax rule that made SALT payments deductible for employers, but not for employees, could be avoided if the taxing government shifted the nominal tax obligation from employee to employer. Daniel Hemel has argued that such a possibility is one reason why the federal tax law should not treat business owners' and investors' SALT payments more favorably than those of other taxpayers.[10]

That argument, however, does not apply to property and sales taxes. The state cannot nullify a rule that allows the SALT deduction for business, but not for nonbusiness, property and sales taxes by shifting the obligation to pay to the business. Because the underlying payments that trigger property and sales taxes run from individuals to business, rather than from businesses to individuals, shifting the payment obligation to business does not provide the individual with the deduction. Such a shift only replaces the individual's tax payment with a higher (and still non-deductible) payment for the goods or services. After payment of the tax (and taking the deduction), the business is left with the same net income. For example, with the property tax, the tenant pays the tax either directly when the law imposes the burden on him or indirectly when the burden is imposed on the landlord. Since rent is not deductible, the payment is not deductible and it cannot be rendered effectively deductible to the tenant

[8] Louis Kaplow, Fiscal Federalism and the Deductibility of State and Local Taxes under the Federal Income Tax, 82 Virginia Law Review 413 (1996).
[9] A 20 percent tax on pre-tax wages is equivalent to a 25 percent tax on post-tax wages.
[10] Hemel, Easy on the Salt, at 18-19.

by shifting the obligation to the landlord. In contrast, the wage tax can be made effectively deductible to the employee by shifting the obligation from employee to employer. The shift is effective with the wage tax because the employer does not pay the additional $25,000 salary to the employee that would otherwise go to pay the tax.

Moreover, the federal government can still prevent the taxing government's attempt to provide its resident employees with the deduction by shifting the wage tax obligation to the employer. What federal law needs to do is treat any wage tax paid by the employer as additional wages received by the employee. Returning to the example, the employee, then, would pay federal income tax on $125,000 income even if the wage tax obligation is imposed on the employer.[11]

Throwing SALT: General Income Taxes

Above, I argued that if Congress were to eliminate the SALT deduction for nonbusiness tax payments, it should still allow the deduction for business tax payments. That argument, however, does not imply that all SALT taxes paid by business owners and investors should be deductible in all circumstances. Specifically, business owners and investors should be treated the same as individual taxpayers with respect to state and local general income taxes. Thus, in this section I argue that if the Internal Revenue Code does not provide a deduction for nonbusiness state and local income tax payments, then it should not allow a deduction for business state and local income tax payments either.

The usual argument against allowing a deduction for state and local income taxes is that in large part the revenue from such taxes provides residents with services they would otherwise purchase with after-tax dollars. The connection between the taxes one pays and the benefits one receives is very rough, but typically there are no good and feasible means of measuring the value of the services received by individual taxpayers. If those values were readily measurable, residents could be taxed on the services they receive.[12] However, because such measurement is not feasible, the disallowance of the nonbusiness SALT deduction (including general income taxes) is justified on the grounds that taxes paid provide a very rough approximation of the services received.

The above argument is stretched, perhaps past breaking, when it is applied to taxpayers who hold business and investment interests far away from where they live. Not surprisingly, out-of-state business owners and investors receive few, if any, benefits where they earn income and the benefits they do receive are subject to taxation. Out-of-state business owners and investors typically do not send their children to the local schools, drive on the local roads, rely on the local first responders for emergency services, or visit the local parks. Instead, they typically receive these benefits where they

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[11] Alternatively, the federal government could deny the employer a deduction for wage taxes paid. Although this would place the employer and employee on par, symmetry is not the rationale. Instead, the employer is paying the tax as a surrogate for the employee. Either including wage taxes paid by the employer in the employee's income or denying the employer a deduction for wage taxes paid would also eliminate the incentive for employees to become independent contractors.

[12] In that case, denying residents a deduction for their taxes paid and requiring them to include the excess of their services received over their taxes paid or allowing them to deduct the excess of their tax payments over their services received would provide an accurate measure of the impact of state and local government taxing and spending policies on their income.

reside, not where they earn income. Nonetheless, business owners and investors still benefit from having these services available. Locally provided services increase the value of distant owners' investments, raise their income, and protect their interests. However, these benefits are not consumed directly, but rather have a positive financial impact on the distant owner, which is generally taxable, at least eventually under federal law. For example, rental property is more valuable and tenants will pay higher rents in areas with good services, such as strong schools and beautiful parks. That business owners and investors are taxed where they earn income might suggest allowing them to take the SALT deduction for general income taxes (paid to other states) on the grounds that deductions incurred to earn taxable income should be permitted.

That conclusion, however, ignores a difference between general income taxes and other state and local taxes. Property, wage and sales taxes are imposed on specific transactions and thus raise the cost of engaging in those transaction. When the transaction is for consumption, then the tax is a cost of consumption; when the tax is incurred in operating a business or holding an investment, it is a cost of engaging in that business or investment. If a taxpayer does not engage in those specific activities, then the taxpayer does not incur those costs. If investors and business owners were to change the location or nature of their work and investment, they would incur different tax liabilities even if their total income (after such taxes) was not affected.

A general income tax is different. A general income tax is not imposed on a specific type of transaction, but applies to all income. In other words, with a comprehensive income tax, the tax is not a cost of earning income, but is instead paid out of earned income. Accordingly, if one works out-of-state for part of the year and pays tax out-of-state, that tax is a rough substitute for the tax one would have paid working at home. The logic is the same with investments. General income taxes are uses of income, not costs of earning income.

Accordingly, allowing a federal SALT deduction for general income tax payments would, for example, encourage owning a business over working as an equally well compensated employee. If the deduction were allowed only for out-of-state income, on the grounds that one typically does not consume much in the way of out-of-state benefits, then the deduction would encourage out-of-state over in-state activity. If for the home-state-bound, income taxes are a rough estimate of benefits received, then those who substitute out-of-state activity for in-state activity are substituting out-of-state taxes for in-state taxes, and should be denied a deduction on the same grounds: the out-of-state income tax payments are a rough (and irrebuttable) estimate of the in-state benefits received. Thus, if taxpayers are not permitted a SALT deduction for nonbusiness general income taxes, then there should be no deduction for business general income taxes.[13]

Arguably, the above distinction can be found or read into the House bill, although it is far from clear. The Ways and Means Committee description of H.R. 1 provides that "individuals would not be allowed an itemized deduction for state and local income or sales taxes, but would be entitled to a deduction for state and local income or sales taxes paid or accrued in carrying on a trade or business or

[13] Whether a tax is a general income tax is not a question of labels, but of economic substance. Assume a state imposes an income tax, a real property tax, and a personal property tax. Assume further that the income tax is broad, but it excludes income from personal property. In that case, the personal property tax is part of a general income tax and should not be deductible, but the real property tax is not part of the general income tax and should be deductible.

producing income." State and local general income taxes paid by business owners and investors are by the above logic not incurred in carrying on a trade or business or in producing income the same way that sales and other taxes are incurred in carrying on a trade or business or in producing income. Admittedly, this is not how the "incurred in carrying on" language has generally been read, but it could be read that way if the provision takes effect.

Conclusion: A Pinch of SALT

H.R. 1's provision that individuals cannot generally deduct SALT payments except for those payments incurred in carrying on a trade or business or in producing income has generated a storm of controversy. The provision has been characterized as a giveaway to the very wealthy and as fundamentally unfair. However, it is not illogical, unprincipled or unfair to treat some SALT payments more favorably for business owners and investors than for other taxpayers. Starting with the premise that the SALT deduction would be eliminated for nonbusiness SALT payments, the House bill is too generous in allowing the deduction for all business SALT payments and the Senate bill is too stingy in denying the deduction for all business SALT payments. Given the plausible (if not universally accepted) view that individuals should not be able to deduct their SALT payments because those payments largely go to provide consumption, business owners and investors should still be allowed to deduct SALT payments incurred in earning taxable income. Specifically, property taxes, wage taxes and sales taxes incurred by business owners and investors should remain deductible even if individuals are generally denied those deductions. Nonetheless, business owners and investors should not be allowed to deduct state and local general income taxes because those taxes are not incurred in earning income, but are imposed on income. Moreover, the language of H.R. 1 arguably would permit this result (with some regulatory backing from Treasury) since only taxes incurred in operating a trade or business or in producing income are deductible and general income taxes can be understood as not incurred in operating a trade or business or in producing income, but rather are imposed on one's overall income.