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In this viewpoint, Knoll discusses the disparate federal income tax treatment of business and personal state and local taxes under the Tax Cuts and Jobs Act. Starting from the premise that individual, nonbusiness SALT payments are not deductible, Knoll considers how business SALT payments should be taxed. He concludes that investors and businesses, including both passthrough businesses and corporations, should be allowed to deduct state and local property and sales taxes but not general income taxes.

Table of Contents

Introduction

Among the most controversial of the revenue-raising provisions contained in the Tax Cuts and Jobs Act is the limitation placed on individuals' state and local tax deductions.[1] For many years, individual taxpayers have been able to deduct most SALT payments.[2] Starting in 2018, individuals can only deduct up to $10,000 of SALT payments not incurred in a taxpayer's trade or business or in the production of income.[3] The loss of the SALT deduction was painful enough, but the outcry intensified when it became clear that individual taxpayers would still be able to deduct SALT payments incurred in a trade or business or in the production of income and that corporations would also keep their SALT deductions. Although many middle-income taxpayers can still claim the deduction because they operate a small trade or business, the benefits of the trade or business exception will be heavily concentrated among the wealthy. Most ordinary taxpayers will take at most the $10,000 deduction — and then only if they itemize their deductions. Wealthy business owners, investors, and corporations will take much larger deductions. The disparate treatment of ordinary taxpayers and wealthy business owners, investors, and corporations has been widely criticized as unfair.

In this article, I consider the question of what the conceptually correct federal income tax treatment of business and investment SALT payments (which I will refer to as business SALT payments) starting from the premise that

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

[2]IRC section 164. However, sales taxes are generally deductible only in lieu of income taxes. IRC section 164(b)(5).

[3]IRC section 164(b)(6)(B).

individuals' nonbusiness SALT payments are not deductible. I argue that a more favorable treatment of business SALT payments than of nonbusiness SALT payments can be an appropriate policy for some taxes and under some circumstances. Specifically, I argue that business owners and investors should be permitted to deduct state and local property, sales, and wage taxes incurred in operating a trade or business or in making an investment, but they should not be permitted to deduct general state and local income taxes on their trade or business and investment income.

As Daniel Hemel recently noted, 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, which is made about SALT payments generally, is offered most frequently and forcefully regarding 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 argument is that if the government did not provide those services, taxpayers would otherwise purchase those or similar 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 homeowners who live in their own houses a deduction for their property taxes. Given that policy, how should federal tax law treat the property taxes paid by an owner of a rental unit? Should the owner of a residential dwelling unit who rents it to a 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 herself? The following sections address that question and then extend the analysis to other state and local taxes.

Real Property Taxes

Consider the following example. Assume units in a condominium building rent for $12,500 annually and that the annual property tax payment, which is paid by the owner, is $2,500. Thus, the tenant pays $12,500 in rent, out of which the landlord pays $2,500 in property tax, leaving the landlord with an after-tax profit of $10,000.[5] If the owner can deduct her property tax payments, she reports $10,000 taxable income; if not, she reports $12,500.

Between the two, $10,000 is a better measure of her federal before-tax income than $12,500 is. Her economic income is $10,000, not $12,500, as she has $10,000 to spend on herself before paying her federal income taxes. In effect, the landlord 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. If the federal law were to deny the landlord the deduction, she would in effect be taxed on the $2,500 she collects from the tenant and passes onto the tax collector. That is, the federal government would tax her on $2,500 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, $2,500 was indirectly a payment of property tax. And that payment was not deductible by the tenant because rental payments on residences are not deductible.

Further, 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 from a long-term capital asset, such as residential real estate, over the

[4] *See* Daniel Hemel, "Easy on the SALT: A Qualified Defense of the Deduction for State and Local Taxes," SSRN (Oct. 28, 2017).

[5] To focus on property taxes, I assume no other costs to the landlord.

investor because landlords would pay tax on the full rent they receive but could not deduct the property taxes they pay.[6]

It might seem that the owner-occupier and the owner-landlord are similarly situated and should be taxed the same, but there are important tax differences that suggest otherwise. The owner-occupier spends $2,500 in real property taxes to consume $12,500 of nontaxable services.[7] In contrast, the owner-landlord incurs $2,500 in real property taxes to generate $12,500 of taxable income. As a 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' state and local property tax payments is consistent with that general rule. The owner-occupier would be denied a deduction because his expenditure generates consumption. In contrast, the owner-landlord would receive a deduction because her expenditure generates taxable income.[8]

The above principle — that business SALT payments should be deductible even if nonbusiness SALT payments are not deductible — is not limited to real estate taxes. It applies equally to personal property taxes — an admittedly small class of taxes. The principle also applies to the much larger class of sales taxes. At times, federal law has denied individuals a deduction for sales taxes because those expenditures are part of the cost of consuming taxable goods and services.[9] Even so, businesses should be able to deduct the sales taxes they pay. For example, the sales taxes a car dealer pays on its office furniture is part of the dealer's cost of operating the dealership. It is a cost of her selling and servicing automobiles. Moreover, if the dealer were disallowed a deduction for the sales taxes she pays, then presumably she should be required to include in income the sales taxes she collects when she sells cars to customers, but she should not be allowed a deduction when she remits those sale taxes.

Wage Taxes

Another common SALT is the wage tax, which is typically imposed on employees. Louis Kaplow has pointed out that if under federal law employers, but not employees, can deduct wage taxes, the taxing government can undercut the impact of a federal law denying employees a deduction for their SALT payments by imposing the wage tax on the employer, rather than the employee.[10] For example, assume a state initially imposes a 20 percent wage tax on employees. 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 income tax on $100,000. Assuming, however, that the employee's 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 elimination of its residents' wage tax deductions 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.[11] 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 effectively deductible for federal tax purposes. Thus, a federal 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. Hemel has suggested that such a possibility is one reason why the federal tax law should not treat the SALT

[6] That advantage would be in addition to the nontaxation of imputed service income, which already provides taxpayers with a tax advantage from owning their own homes.

[7] 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.

[8] 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.

[9] 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. IRC section 164(b)(5).

[10] Louis Kaplow, "Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax," 82 *Va. L. Rev.* 413 (1996).

[11] A 20 percent tax on pretax wages is equivalent to a 25 percent tax on post-tax wages.

payments of business owners and investors more favorably than those of other taxpayers.[12]

That argument, however, does not apply with the same force to property and sales taxes. In contrast with wage 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 the tax to the business. Because the underlying payments that trigger property and sales taxes run from individual to business rather than from business to individual, shifting the payment obligation to business does not provide the individual with the effective deduction. Such a shift only replaces the individual's tax payment with a higher — and still nondeductible — payment for goods or services. After paying 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 by shifting the payment 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 state or local government from providing its resident employees with a deduction for wage tax payments by shifting the obligation to the employer. All federal law needs to do to prevent the workaround is to 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.[13]

General Income Taxes

I have 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 regarding general income taxes. Thus, 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 rough, but there are typically no feasible means of measuring the value of the services received by individual taxpayers.[14] Accordingly, 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 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

[12]Hemel, *supra* note 4, at 18-19.

[13]Alternatively, the federal government could deny the employer a deduction for wage taxes paid. Although that 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. The effect, however, is precisely the same only if the employer and the employee are taxed at the same rate. Also, either including wage taxes paid by the employer in the employee's income or denying the employer a deduction for wage taxes paid would eliminate the incentive for employees to become independent contractors.

[14]If those values were readily measurable, residents could be taxed on the difference between the services they receive and the state and local taxes they pay. That could most easily be accomplished by including services received in income and deducting state taxes paid from income.

benefits they do receive are subject to taxation. Out-of-state business owners and investors typically do not send their children to local schools, drive on local roads, rely on local first responders for emergency services, or visit local parks. Instead, they receive those benefits where they live, not where they earn income. Nonetheless, business owners and investors still benefit from having those services available. Locally provided services increase the value of distant owners' investments, raise their income, and protect their interests. However, those 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 transactions. 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 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 state and local business income tax payments would 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 services, 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 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.[15]

The Tax Cuts and Jobs Act is consistent with this approach. Except for the $10,000 general SALT deduction, individuals cannot deduct state and local income taxes even if incurred in a trade or business or an investment.

Corporate Taxes

Corporations are subject to the full range of state and local taxes. They pay sales taxes, property taxes, income taxes, and — when imposed on the employer — wage taxes. Under current law, corporations can deduct all their SALT payments.

Once again, I take as a starting point the elimination of the deduction for nonbusiness SALT payments because these payments roughly compensate for the services received. Because sales, property, and wage tax payments are part of

[15]Whether a tax is a general income tax is not a question of labels, but of 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 by business owners and investors; however, the real property tax is not part of a general income tax and should be deductible by business owners and investors.

the cost to the corporation of earning taxable income, those SALT payments should be deductible for the same rationale as given above.

The more difficult question concerns the federal tax treatment of state and local corporate income taxes. The corporate income tax can be conceptualized as a tax on corporate equity capital because interest payments are generally deductible whereas dividends are not. As a result, state and local corporate income taxes raise the cost to the corporation of equity capital, which suggests allowing the deduction.

The United States, however, has a classic corporate income tax, which subjects corporate income to two levels of federal taxation — first at the corporate level and then at the investor level. Whatever the merits of double economic taxation, the double taxation of corporate income is a long-standing and well-established feature of the U.S. federal tax system. Accordingly, denying both the individual investor in corporate equity and the corporation a deduction for state and local general individual and corporate income taxes acknowledges the double taxation of corporate income. It also acknowledges that general income taxes are not a cost of earning income, but are instead imposed on income. Thus, corporations should not be allowed to deduct their state and local general income taxes.

The Tax Cuts and Jobs Act, however, takes the opposite approach. The $10,000 general SALT deduction limitation applies only to individuals, not to corporations. And the conference explanation of the reconciliation bill, which makes clear that individuals cannot deduct state and local income taxes beyond the $10,000 limit, even if those taxes are incurred in a trade or business or an investment, does not refer to corporations' SALT payments.

Conclusion

The Tax Cut and Jobs Act provision that prevents individuals from deducting SALT payments (in excess of $10,000), 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 criticized as a giveaway to the wealthy and as fundamentally unfair. However, it is not illogical, unprincipled, or unfair to treat business owners and investors' SALT payments incurred in operating a trade or business or in holding an investment more favorably than taxpayers' nonbusiness 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, including corporations, 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.

The above logic appears to underlie the Tax Cuts and Jobs Act's treatment of individuals' state and local taxes. State and local taxes are not generally deductible by individuals (except for the first $10,000). However, individuals can deduct state and local non-income taxes incurred in operating a trade or business or an investment, but they cannot deduct general income taxes even if incurred in operating a trade or business or investment. In contrast with the above logic, corporations would still appear to be allowed to deduct their income taxes even though those taxes are not a cost of earning income. In the context of the U.S. classical corporate income tax, with both the investor and entity level taxes, state income taxes should not be deductible from federal income at either the investor or the corporate level. ■