ITEP INSTITUTE ON TAXATION AND ECONOMIC POLICY

ITEP Comments and Recommendations on REG-107431-19

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Thank you for proposing these regulations. I find them to be largely reasonable, with one exception.

I am concerned by the possibility that owners of passthrough businesses may be able to circumvent the $10,000 SALT deduction cap of section 164(b)(6) by recharacterizing the nondeductible portion of their state and local income tax payments as deductible expenses associated with carrying on a trade or business.

Fortunately, this is not a concern under the safe harbor described in 1.162-15(a)(3)(ii) because the safe harbor "does not apply if the credit received or expected to be received reduces a state or local income tax."

But the possibility seems to arise earlier in this section, under Example 2 provided in 1.162-15(a)(2)(ii). In this example, a partnership (P) may deduct a $1,000 payment to a charity as a business expense even if it "expects to receive a $1,000 income tax credit on account of P's payment, and under State N law, the credit can be passed through to P's partners." In this example, the business advertises the program and anticipates an unspecified level of increase in its revenue.

To allow for a more detailed exploration of this example, I will assume that P spends $200 advertising its payment.

In this case, the payment triggers a $1,200 increase in P's deductions claimed under section 162, but a $1,000 drop in potential deductions under section 164. My concern, however, is that if each of the partners pays more than $10,000 in state and local income taxes, the $1,000 decline in section 164 deductions will not occur (that is, each partner will continue to deduct the same $10,000 maximum state income tax bill as before) and the partners will have collectively enjoyed a $1,200 increase in their federal tax deductions. That $1,200 deduction would result in a $444 federal tax savings if claimed against the top 37 percent personal income tax rate, even though this maneuver involved a net expenditure of just $200 (this is the combined impact of the $1,000 payment and $200 advertising campaign, mostly offset by the automatic $1,000 state income tax credit).

In other words, the federal income tax consequences alone make the payment profitable for the partners. By redirecting a mandatory $1,000 payment away from their state government and toward a charity instead, they have avoided the limitations of section 164(b)(6).

Notably, the background section of Rev. Proc. 2019-12 included a helpful passage that was left out of these proposed regulations:

> "Similarly, in the case of a business entity other than a C corporation that is regarded as separate from its owner for all federal tax purposes under section 301.7701-3 of the Procedure and Administration Regulations (passthrough entity) and that is operating a trade or business within the meaning of section 162, to the extent the credit received in return for such a payment can reduce the passthrough entity's tax liability, it is reasonable to conclude that there is a direct benefit to the passthrough entity in the form of a reduction in the state or local taxes the entity would otherwise have to pay. **However, under the principles of sections 702 and 1366, the deductibility of the payment must be determined at the level of the individual owners of the entity if the credit received or expected to be received will reduce a state or local income tax subject to the limitations in section 164(b)(6)."** (emphasis added)

In the context of Example 2 of 1.162-15(a)(2)(ii), this passage seems to suggest that the $1,000 payment to the charity would not be deductible under section 162 at the individual level if that payment is offset by a $1,000 state income tax credit that reduces only the nondeductible portion of the partners' state income tax liability. In this specific case, then, if the payment would not have been deductible (because of section 164(b)(6)) if it had been made to a state government, then it would also not be deductible under section 162 if it is made to a charity.

But Example 2 makes no mention of this possibility and instead declares unequivocally that "P may treat the $1,000 payment as an expense of carrying on a trade or business under section 162" and that "this result is unchanged" if an offsetting state income tax credit is claimed.

In sum, it appears that the exception proposed in 1.162-15(a)(3)(ii)(C) is intended largely to prevent circumvention of the SALT deduction cap in section 164(b)(6). But Example 2 of 1.162-15(a)(2)(ii) needlessly leaves open the possibility of this circumvention by failing to adequately describe the difference between using a state income tax credit to offset taxes that would have been deducted under section 164, or using that credit to offset taxes that would have been nondeductible because of section 164(b)(6).

These regulations would benefit from the inclusion of a statement of a general rule of principle along the following lines: "In any case where a state or local tax credit has the effect of reducing an otherwise nondeductible state or local tax liability, the payment giving rise to the state or local tax credit cannot itself be deductible." Such a statement would offer clarity to taxpayers. Moreover, by making clear that the regulations are meant to consistently deny the use of state or local tax credits to circumvent the limitation of section 164(b)(6) in all instances, such a statement could also help to insulate these regulations from charges that they are arbitrary and capricious.