TOO MUCH SALT: REJECTING THE PASS-THROUGH ENTITY TAX AS A SALT DEDUCTION CAP WORKAROUND

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INTRODUCTION

In 2021, New York pass-through business owners avoided paying billions of dollars in federal taxes.[1] In the same year, New Jersey pass-through business owners saved over $500 million in federal taxes.[2] And following this lead, over 400,000 Illinois pass-through business owners will save thousands of dollars in the 2022 tax year under newly-passed state-level tax legislation.[3] The federal government currently caps state and local tax (SALT) deductions at $10,000.[4] But New York, New Jersey, and Illinois have passed legislation providing pass-through entities[5] with a workaround to this cap, leading to these large tax

J.D., Duke University School of Law, expected 2023; B.A., University of Florida, 2020. Thank you to Professor Amelia Ashton Thorn for her guidance in writing this Note, as well as to Professor Lawrence Zelenak for his help in developing the topic of this Note and sparking my interest in tax law. Thank you also to the editing team of the *Duke Journal of Constitutional Law & Public Policy* and to my classmates in the Scholarly Writing Workshop for the time they spent reviewing this piece. And, of course, thank you to my all friends and family who have supported me throughout law school.

1. Richard Rubin & Jimmy Vielkind, *New York Business Owners Sidestep Billions in Federal Taxes With State's Help*, WALL ST. J. (Jan. 10, 2022, 4:51 PM), https://www.wsj.com/articles/new-york-business-owners-sidestep-billions-in-federal-taxes-with-states-help-11641846435.

2. Alan D. Sobel, *Why NJ Businesses Should Take the BAIT*, NEW JERSEY BUSINESS MAGAZINE (Jan. 11, 2022), https://njbmagazine.com/special-sections/njcpa-special-section-tax-preparations-beyond-the-pandemic/why-nj-businesses-should-take-the-bait/.

3. Shabnam Danesh, *New Law Will Save Small Business Owners in Illinois Thousands of Dollars this Tax Season*, WGN-TV (Jan. 18, 2022, 10:51 AM), https://wgntv.com/news/new-law-will-save-small-business-owners-in-illinois-thousands-of-dollars-this-tax-season/.

4. Rubin & Vielkind, *supra* note 1.

5. The term "pass-through entity" refers to businesses where "profits flow through to owners or members and are taxed under the individual income tax" as opposed to the corporate income tax. This usually includes sole proprietorships, partnerships, limited liability companies,

avoidances.[6] These states' legislation reflects a growing trend—seven other states enacted similar legislation in 2022,[7] bringing the total number of states with SALT cap workaround legislation to twenty-nine.[8]

As the number of states providing for a pass-through entity workaround has increased, so have political tensions. But in contrast to the typical Republican-Democratic division, Republicans and more progressive Democrats generally support the SALT cap, while more moderate Democrats tend to argue that it should either be raised or eliminated.[9] Republicans who support the SALT cap claim that the SALT deduction subsidizes high-tax blue states' progressive benefits,[10] while more progressive Democrats who support the cap contend that the deduction disproportionately benefits the wealthy.[11] But moderate Democrats view raising (or eliminating) the cap as a method to mitigate the tax hikes that the Trump administration's Tax Cuts and Jobs Act of 2017 caused in blue states.[12] Given the amount of people affected by the SALT cap, the outcome of this debate could have "huge electoral consequences."[13] This Note argues that pass-through entity workaround legislation goes against good tax and public policy, and accordingly, that the U.S. Department of the Treasury (the "Treasury Department") should issue regulations disallowing it.

Generally speaking, the SALT deduction works by permitting individual taxpayers to deduct what they have already paid in state and

and S corporations. For the pass-through entity workaround, however, this term is more limited and generally includes only partnerships and S corporations. *What Are Pass-Through Businesses?*, TAX POLICY CENTER, https://www.taxpolicycenter.org/briefing-book/what-are-pass-through-businesses (last visited Mar. 15, 2022); *see also* I.R.S. News Release IR-2020-252 (Nov. 9, 2020) (issuing guidance on the SALT deduction workaround specifically for partnerships and S corporations).

6. Rubin & Vielkind, *supra* note 1; Sobel, *supra* note 2; Danesh, *supra* note 3.

7. *See SALT Parity*, MAIN STREET EMPLOYERS, https://mainstreetemployers.org/salt/ (last visited Dec. 20, 2022) (providing a list of the states that have enacted SALT Parity legislation, and the dates they did so).

8. *See id.* (providing a list of twenty-nine states that have enacted SALT Parity legislation).

9. *See* Abby Vesoulis, *A Wonky Tax Break for the Well-Off is a Bigger Problem for Democrats Than You'd Think*, TIME (Dec. 16, 2021, 12:50 PM), https://time.com/6128775/salt-cap-democrats-divided/ (describing Republican and Democratic arguments for the SALT cap and Democratic arguments against the cap).

10. *See id.* ("Republicans argued that the federal government should not subsidize the progressive benefits that coastal blue states offer . . . .").

11. *Id.*

12. *Id.*

13. *Id.*

local taxes from their federal taxable income.[14] The idea here is "if [a taxpayer] forked over money in state income tax, property taxes and the like, [she] shouldn't also have to pay Uncle Sam taxes on that same money."[15] Taxes covered under the "state and local tax" umbrella include income and property taxes collected by the state, city, county, or municipality where the taxpayer lives.[16] Although individual taxpayers may always deduct their property taxes, they must choose between deducting either their income taxes or their sales taxes.[17] Additionally, taxpayers may only take advantage of the SALT deduction if they itemize their deductions.[18]

For example, suppose a taxpayer earned $400,000 of ordinary income in 2021.[19] And suppose this taxpayer lives in North Carolina, which had a flat state individual income tax of 5.25 percent in 2021.[20] She would consequently owe $21,000 in state income tax.[21] As for federal income tax, before considering any deductions, this taxpayer would fall in the 35 percent tax bracket and would owe roughly $114,544 in federal income tax.[22] So, without the SALT deduction, the taxpayer would owe approximately $135,544 in combined federal and

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14. Amelia Josephson, *Explaining Changes to the State and Local Tax Deduction*, SMARTASSET (Jan. 5, 2022), https://smartasset.com/taxes/trumps-plan-to-eliminate-the-state-and-local-tax-deduction-explained.

15. Susan Milligan, *The War Against New Jersey (and Other Blue States)*, USNEWS (Nov. 26, 2021), https://www.usnews.com/news/the-report/articles/2021-11-26/democratic-states-battle-over-salt-tax-rules.

16. *Id.*

17. *Id.*

18. *Id.*

19. For the purpose of clarity, this example will assume that the taxpayer is a single filer who has elected to itemize her deduction and to deduct her state income tax instead of her sales taxes. Additionally, no deductions or credits other than the SALT deduction will be considered. Accordingly, this example will examine only the taxpayer's individual income tax. This should not notably affect the outcome of the hypothetical, as none of the cities in North Carolina have local income taxes, and the property tax in North Carolina is only 0.77 percent. *See North Carolina Paycheck Calculator*, SMARTASSET, https://smartasset.com/taxes/north-carolina-paycheck-calculator (last visited Mar. 8, 2022) ("No cities in North Carolina have local income taxes."); *North Carolina Property Tax Calculator*, SMARTASSET, https://smartasset.com/taxes/north-carolina-property-tax-calculator (last visited Mar. 8, 2022) ("The average effective property tax rate in North Carolina is 0.77%, well under the national average of 1.07%.").

20. *Tax Rate Schedules*, NORTH CAROLINA DEPARTMENT OF REVENUE, https://www.ncdor.gov/taxes-forms/tax-rate-schedules (last visited Mar. 8, 2022).

21. $190,000 multiplied by 0.0525 equals $9,975.

22. $47,843 plus the product of 0.35 times the difference between $400,000 and $209,425 equals $114,544.25. *See* Tina Orem, *2021-2022 Tax Brackets and Federal Income Tax Rates*, NERDWALLET (Mar. 2, 2022), https://www.nerdwallet.com/article/taxes/federal-income-tax-brackets (providing a table that shows that a tax rate of 35 percent applies to single filers with a taxable income bracket between $209,426 to $523,600 and that the tax owed for that bracket is $47,843 plus 35 percent of the amount over $209,425).

state income taxes.[23] The SALT deduction, however, allows the taxpayer to deduct her state income tax from the federal taxes she owes.[24] By deducting the $21,000 that the taxpayer already paid in state income tax, she could reduce her federal taxable income from $400,000 to $379,000.[25] In turn, the lower taxable income—resulting from the SALT deduction—would result in a $7,350 reduction in income tax owed.[26] The more money the taxpayer makes, and the higher the state and local taxes are, the more valuable the deduction becomes.[27] For certain taxpayers, this could mean that the deduction may be high enough to lower their tax bracket.[28]

In 2017, however, Congress passed the Tax Cuts and Jobs Act (TCJA).[29] Among other reforms to the Internal Revenue Code of 1986,[30] the TCJA introduced a $10,000 limit on the SALT deduction (and a $5,000 limit for married individuals filing separate returns) through the end of 2025.[31] Prior to the introduction of this limit, individual taxpayers could deduct the entire value of their state and local taxes—a value which could far exceed $10,000—from their federal taxes.[32] Accordingly, this limit, or cap, has drastically reduced the amount of state and local taxes that individuals can deduct.[33] In

23. $21,000 state income taxes plus $114,544.25 federal income tax equals $135,544.25 total.

24. *See* Josephson, *supra* note 14 ("The state and local tax (SALT) deduction allows taxpayers of high-tax states to deduct local tax payments on their federal tax returns.").

25. $400,000 gross income minus $21,000 in state income tax equals $379,000.

26. $47,843 plus the product of 0.35 times the difference between $379,000 and $209,425 equals $107,194.25. And $114,544.25 minus $107,194.25 equals $7,350. *See* Orem, *supra* note 22 (providing a table that shows that a tax rate of 35 percent applies to single filers with a taxable income bracket between $209,426 to $523,600 and that the tax owed for that bracket is $47,843 plus 35 percent of the amount over $209,425).

27. Josephson, *supra* note 14.

28. *See What Are Tax Brackets?*, TURBOTAX (Dec. 22, 2021, 3:26 PM), https://turbotax.intuit.com/tax-tips/irs-tax-return/what-are-tax-brackets/L8jeM6XaJ ("Deductions are a way for you to reduce your taxable income, which means less of your income is taxed in those higher tax brackets.").

29. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054.

30. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (amended 2017).

31. *See id.* (codified as amended at I.R.C. § 164(b)) ("[T]he aggregate amount of taxes taken into account under [the paragraphs and subsections detailing the SALT deduction] for any taxable year shall not exceed $10,000 ($5,000 in the case of a married individual filing a separate return).").

32. *See State and Local Tax (SALT) Deduction*, TAX FOUNDATION, https://taxfoundation.org/tax-basics/salt-deduction/ (last visited Mar. 8, 2022) ("[B]efore the TCJA, there was no cap to the value of the SALT deduction.").

33. *See* William B. Barker, *The Tax Cuts and Jobs Act of 2017: The Salt Deduction, Tax Competition, and Double Taxation*, 56 SAN DIEGO L. REV. 73, 74 (2019) ("In [limiting the maximum allowable SALT deduction to $10,000], Congress eliminated a substantial portion of one of the largest deductions available to individuals.").

doing so, it has become one of "the most widely publicized and controversial features" of the TCJA.[34]

Consider the previous example, where the taxpayer made $400,000, paid $21,000 in North Carolina state income taxes, and used the SALT deduction to reduce the taxes she owed by $7,350.[35] With the $10,000 cap in place, that taxpayer would now only be able to deduct $10,000 from her federal taxable income (as opposed to $21,000). Her federal taxable income under the $10,000 SALT deduction cap would accordingly be $390,000.[36] And with this higher taxable income, the limited SALT deduction would save her just $3,500 in taxes owed—less than half of the $7,350 she would have saved if there was no value limit on the deduction.[37]

This example demonstrates how the SALT deduction cap shifts taxpayers' income (that would otherwise be exempt from taxation) out of their hands and into the hands of the federal government. In high-tax states, taxpayers' deductions are disproportionately reduced by the flat $10,000 limit, meaning those states "foot[] more of the nation's bill than the rest of the country."[38] Taxpayers in these high-tax states must pay more taxes than their low-tax state counterparts, and the resulting lower after-tax income for these taxpayers decreases consumer consumption, in turn causing their states to lose revenue.[39]

As a response to this restriction, states have turned to various methods to convert SALT taxes into taxes not subject to the SALT cap (e.g., taxes deductible as business expenses).[40] Avoiding the cap allows states to maintain their current tax rates without either (1) reducing spending on government-sponsored programs and services or (2)

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34. Lawrence Zelenak, *SALT Ceiling Workarounds and Tax Shelters*, TAX NOTES (July 23, 2018), https://www.taxnotes.com/exempt-organizations/tax-cuts-and-jobs-act/salt-ceiling-workarounds-and-tax-shelters/2018/07/30/287f2.

35. *See supra* text accompanying notes 19–28.

36. $400,000 gross income minus $10,000 state taxes paid, capped at $10,000.

37. $47,843 plus the product of 0.35 times the difference between $390,000 and $209,425 equals $111,044.25. And $114,544.25 minus $111,044.25 equals $3,500. *See* Orem, *supra* note 22 (providing a table that shows that a tax rate of 35 percent applies to single filers with a taxable income bracket between $209,426 to $523,600 and that the tax owed for that bracket is $47,843 plus 35 percent of the amount over $209,425).

38. *See* Milligan, *supra* note 15 ("The deduction has a disproportionate impact not just on wealthy taxpayers . . . . It also hits a broader swath of taxpayers in states with higher state and property taxes—and higher costs of living.").

39. *See id.* ("[W]ealthy taxpayers . . . pay[] more actual dollars in state income taxes and likely more in property taxes.").

40. *See* Zelenak, *supra* note 34 ("Different states have turned to different strategies.").

increasing their residents' tax burdens.[41] In other words, state governments are not forced to choose between decreasing benefits or raising taxes—they can continue to provide the same benefits without increasing taxes for their residents. Methods used to work around the SALT cap include using charitable tax credits and converting employee income taxes to employer payroll taxes.[42] More recently, states have begun to enact workaround legislation that establishes a pass-through entity (PTE) level tax to mitigate the effect of the SALT cap.[43] This Note focuses on this latter development.

Although the exact mechanics of the tax workaround vary by state, a typical PTE workaround follows these steps:

> (1) the PTE voluntarily elects to pay tax at the entity level; (2) the PTE owners report their allocable or pro rata share of PTE income on their individual state tax returns, and are then allowed a full or partial credit against their individual tax liability for their allocable or pro rata share of the PTE tax paid by the entity.[44]

Consider, for example, a taxpayer who is a partner in a general partnership along with one other partner, each of whom has equal shares in the profits and control of the partnership (i.e., each is allocated 50 percent of the profits). And suppose that the partnership has a total income of $1 million for the year. Like the partners in most general partnerships, these partners each pay income taxes at an individual level for their share of the partnership's profits.[45] So, if the partners do not use the PTE workaround, each partner would pay individual income taxes on their $500,000 share of the partnership's profits.[46]

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41. *See* Josephson, *supra* note 14 ("In response to the fact that people are paying more in federal taxes [due to the SALT cap], those governments could choose to decrease their local tax rates. This would leave them with less to spend on government-sponsored programs and services.").

42. Zelenak, *supra* note 34.

43. *See* James Dawson & Sonia Shaikh, *And Then There Were Some: Maryland, Virginia, and DC's Stance on Pass-Through SALT Deduction Workarounds*, JD SUPRA (Feb. 1, 2022), https://www.jdsupra.com/legalnews/and-then-there-were-some-maryland-9108991/ ("To assuage the effect of this [SALT deduction] limitation, many states responded by enacting either an elective or mandatory [pass-through entity] level Tax . . . .").

44. *Id.*

45. Priyanka Prakash, *What Is a General Partnership? Pros, Cons & How to Form*, NERDWALLET (May 25, 2021), https://www.nerdwallet.com/article/small-business/general-partnerships#:~:text=Taxes%20in%20a%20general%20partnership,and%20pays%20the%20taxes%20accordingly.

46. $1,000,000 divided by two (the number of partners) equals $500,000 in income per partner.

If the partners instead choose to use the PTE workaround, (1) the partnership would elect to pay taxes on $1 million at the partnership level instead of $500,000 at the individual partner level. This is analogous to a corporation paying the corporate income tax. Then, (2) each partner would report their pro rata share (50 percent) of the partnership tax on their individual state tax return. The state would then provide each partner with a tax credit equal to the amount of taxes on the partners' individual state tax returns. In sum, the partners are essentially refunded for their individual state income tax via the tax credit, and the state instead collects this tax directly from the partnership. The total amount of taxes being paid is the same under both circumstances; the only change is the entity from whom the state receives the tax.

The result of this maneuvering is that the tax paid at the entity level is then deductible from the partners' federal income tax under the business expense deduction instead of under the SALT deduction.[47] Because business expense deductions are not SALT deductions, they are not subject to the SALT cap, and the business owners' federal income tax liability is greatly reduced.[48] Some states have a mandatory PTE tax that works in a similar fashion, except the state "*require[s]* a Pass-Through Entity ('PTE') to pay a tax at the entity level," rather than making it elective.[49]

In response to states passing PTE-level tax legislation, the Treasury Department and the Internal Revenue Service (IRS) issued Notice 2020-75, titled "Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes."[50] The Notice provides that the Treasury Department and IRS "intend to issue proposed regulations" that would affirm the validity of the state-level pass-through entity tax workaround legislation.[51] But it has been over two years since the IRS issued the Notice under the Trump administration, and the IRS—now

47. Dawson & Shaikh, *supra* note 43.

48. *Id.*

49. *Id.* (emphasis added).

50. I.R.S. Notice 2020-75, I.R.B. 1453 (Nov. 9, 2020); S corporations are corporations that are organized under Subchapter S, which allows these corporations to treat income and taxes in the same manner as pass-through entities. Walter D. Schwidetzky, *Integrating Subchapters K and S—Just Do It*, 62 TAX LAW 749, 749 (2009).

51. *See* I.R.S. Notice 2020-75, I.R.B. 1453 (Nov. 9, 2020) ("[The Treasury Department and IRS] intend to issue proposed regulations to clarify that State and local income taxes imposed on and paid by a partnership or an S corporation on its income are allowed as a deduction . . . .").

almost two years into the Biden administration—has yet to issue any regulations on the topic.

This Note argues that the Treasury Department and IRS should issue regulations denying the validity of state legislation that provides for a pass-through entity tax as a method of circumventing the SALT deduction cap. First, Part I examines the legislative history of the SALT deduction and the Tax Cuts and Jobs Act of 2017 to determine Congress's motivation in establishing the deduction and passing the TCJA. Part I concludes that although the SALT deduction was established to prevent double taxation, the SALT cap was passed to limit the tax break that disproportionately benefitted the rich as a result of the SALT deduction, while also mitigating the negative effects the deduction had on the federal government's tax revenue. Part II then provides an analysis of how the IRS has treated other SALT cap workarounds—specifically, the charitable contribution tax credit and payroll tax workarounds—before more closely analyzing the pass-through entity tax workaround and the IRS's announcement of forthcoming regulations in Notice 2020-75. Part III focuses on the traditionally Democrat-leaning and Republican-leaning arguments for and against the SALT deduction and the $10,000 cap and then applies the parties' reasoning to form new arguments regarding the PTE workaround. Finally, Part IV proposes that the Treasury Department and IRS's final regulations should explicitly disallow state-level legislation enabling PTE workarounds due to substance over form and public policy concerns, before addressing the permissibility of SALT deduction cap workarounds more broadly.

I. THE HISTORY OF THE SALT DEDUCTION AND THE SALT CAP

Congress has long provided for a SALT deduction.[52] Even before the first federal income tax was enacted in 1913, the Tariff Act of 1862 allowed for state and local taxes to be deducted from a national income tax to prevent double taxation.[53] But over time, Congress has gradually restricted the deduction's scope,[54] with those in favor of limiting the SALT deduction (i.e., those in favor of imposing a cap) reasoning that

52. Emily Berg, *Just a Pinch of SALT is Not Enough*, 92 TEMP. L. REV. 445, 447 (2020).

53. Julianne Surane, *Legislative History of the SALT Deduction*, A.B.A. SEC. TAX'N 2018 MID-YEAR MEETING, SAN DIEGO 1, 2 (2018), https://www.americanbar.org/content/dam/aba/events/taxation/meetingmaterials/18mid_materials/18mid-tps-perspectives-lang-paper.authcheckdam.pdf.

54. Daniel Hemel, *The Death and Life of the State and Local Tax Deduction*, 72 TAX L. REV. 151, 151 (2019).

reducing the SALT deduction broadens the federal tax base.[55] This Note will examine the PTE workaround in the context of these two conflicting perspectives: that the SALT deduction prevents unfairness but reduces the federal government's revenue.

A. The Early Legislative History to the SALT Deduction

The SALT deduction was introduced in 1862 alongside the United States' first "national" income tax, which served as the precursor to the current federal income tax system eventually enacted in 1913.[56] President Abraham Lincoln signed this national tax into existence "to finance the Union's effort in the Civil War."[57] But even with the purpose of funding a war, the Tariff Act of 1862 (Tariff Act) still allowed taxpayers to deduct "all other national, state, and local taxes, lawfully assessed upon the property or other sources of income of any person" from their gross income.[58] In discussing the need for this deduction, Senator Justin Smith Morrill explained that it was "of 'vital importance' to preserve the principle of federalism and . . . to avoid double taxation."[59] Although the national tax under the Tariff Act was eventually repealed, when Congress established the current federal income tax system in the Revenue Act of 1913, it again allowed for the deduction of state and local taxes.[60]

The SALT deduction was first broadened in 1942 (although, under significantly different circumstances than more recent modifications).[61] The Great Depression caused property values to drop and unemployment to rise, which led states to turn to an alternative method to collect tax revenue: sales tax.[62] Congress responded to the rise of state sales taxes by "explicitly includ[ing] in the Revenue Act of 1942 an allowance for a deduction of state and local retail sales taxes."[63] But the Revenue Act of 1942 increased federal income tax rates as high as 94 percent, meaning that "the state and local tax deduction was

55. *See id.* at 156 ("One motivation for rolling back the SALT deduction as part of the 2017 Act was to broaden the tax base so that Congress could lower rates across the board.").

56. Surane, *supra* note 53, at 3.

57. *Id.* at 2.

58. *Id.* (citing The Tariff Act of 1862, §91, 12 Stat. 543).

59. Surane, *supra* note 53 (citing 37 CONG. REC. 1194 (1862) (statement of Sen. Justin Smith Morrill)).

60. Surane, *supra* note 53, at 3.

61. *See id.* at 4 (explaining the SALT deduction was expanded to include state and local retail sales taxes but that federal income tax rates ranged from 88 to 94 percent).

62. *Id.*

63. *Id.* (citing Revenue Act of 1942, Pub. L. No. 77-753, 56 Stat. 798, 820).

seemingly necessary to prevent the sum of the marginal tax rates for federal and state income taxes from exceeding 100 percent."[64]

But given the significantly lower current marginal tax rates,[65] the necessity of the SALT deduction expansion in 1942 cannot reasonably support an argument for expanding the deduction in the modern era. Moreover, this broad expansion has been largely diminished.[66] Over the next several decades, Congress gradually whittled down the deduction of sales taxes by nixing various state and local sales taxes on specific goods.[67] It was not until Congress passed the Tax Reform Act of 1986, however, that the SALT deduction underwent one of its most significant modifications.[68]

B. The Tax Reform Act of 1986

The Tax Reform Act of 1986 completely repealed the state and local tax deduction for sales taxes.[69] And although the repeal of the sales tax deduction marked a significant amendment to the SALT deduction, the Reagan administration's proposals leading to the Tax Reform Act of 1986 had called for an even more extreme measure: a complete repeal of SALT deductions altogether.[70] Thus, broader arguments against the SALT deduction can be found in the Treasury Department's and President Reagan's proposals for a complete repeal of the SALT deduction.[71] Conversely, Congress's discussions on the floor in the corresponding rejection of that proposal through the Tax Reform Act of 1986 provide arguments in favor of the SALT deduction.[72]

Reagan's Treasury Department essentially viewed the SALT deduction as a federal subsidy to state and local governments that reduced the federal tax base, thus preventing the federal government

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64. Surane, *supra* note 53, at 4.

65. *See* I.R.C. § 1 (providing the current income tax rates imposed, the highest of which is 39.6 percent).

66. *See* Surane, *supra* note 53, at 4–7 (describing how the Revenue Act of 1964 and the Revenue Act of 1978 restricted which sales taxes could be deducted and the Tax Reform Act of 1986 repealed the deduction for general state and local taxes).

67. *Id.* at 6.

68. Surane, *supra* note 53, at 9 (citing Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2116).

69. Surane, *supra* note 53, at 9.

70. *Id.* at 7.

71. *See id.* at 10 ("[I]t seems that the current legislation accepts the arguments found in the Treasury's and President's proposals in 1986 . . . . Thus, the 2017 changes downplay the contrary positions espoused by others in Washington over the years.").

72. *See id.* at 8–9 ("The Joint Committee on Taxation responded to the Treasury's and President's analysis by bringing to light the opposing arguments for keeping the deduction.").

from lowering income tax rates.[73] The logic underlying this view is that if the SALT deduction was reduced, then federal tax revenue would increase, offsetting the reduction of the federal tax base that would otherwise result from lowering income tax rates.[74] In a report to the President, the Treasury Department explained that while the SALT deduction may have been necessary when federal income tax rates exceeded 90 percent, "[g]iven the present levels of tax rates, such an argument is no longer relevant."[75]

The Treasury Department then rebutted the argument that the SALT deduction is "a subsidy that is required to reduce the taxpayer's net cost of paying State and local taxes."[76] It explained that because state and local governments' tax expenditures primarily benefit their own residents, "[s]tate and local taxes merely reflect the benefits of services provided to taxpayers."[77] Therefore, because other states' residents do not benefit from these services, "equity and neutrality" call for states to fund their own benefits, as opposed to using federal funds raised from taxing other states' taxpayers.[78] Further, it argued that it is illogical "to have high Federal tax rates and provide implicit Federal subsidies to spending of State and local governments by allowing deduction for their taxes."[79] Instead, the Treasury urged for the "fairer, simpler, and more neutral" solution of lowering federal tax rates and disallowing the deduction.[80]

In closing, the Treasury Department asserted that the SALT deduction benefits high-income taxpayers to the detriment of other taxpayers.[81] It explained that "itemized deductions were only claimed by [one-third] of all families."[82] Thus, because the SALT deduction was claimed by only a minority of families, repealing the deduction would be unlikely to substantially affect state and local government revenue.[83] This also meant that the deduction likely "benefitted the high-income

73. *Id.* at 7.
74. *Id.*
75. 1 OFF. OF TAX POLICY, U.S. DEP'T OF TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT at 78 (1984) [hereinafter TREASURY REPORT TO THE PRESIDENT].
76. *Id.*
77. *Id.*
78. *Id.*
79. *Id.*
80. *Id.*
81. Surane, *supra* note 53, at 7–8.
82. *Id.* at 7.
83. *Id.* at 8.

individuals in high-income communities" instead of benefitting the general public by increasing the level of services that state and local governments could provide.[84] Because the SALT deduction only benefited those high-income individuals but caused higher federal income tax rates for all taxpayers (including low-income taxpayers), "taxpayers who lived in states and localities with low tax rates were worse off with the deduction."[85]

President Reagan's 1985 tax reform proposal reflected his agreement with the Treasury Department.[86] He similarly argued that although the SALT deduction "benefitted small groups of taxpayers, the cost of the deduction was borne by all taxpayers through higher marginal tax rates."[87] He agreed that "[t]he deduction eroded the federal income tax base," and substantiated this claim with a projection of $33.8 billion in increased revenues for 1988 should the deduction be repealed.[88] Finally, responding to the double taxation argument, President Reagan claimed that taxpayers have "ultimate control over the state and local taxes they pay through the electoral process and their ability to relocate to jurisdictions with more favorable tax policies."[89]

Despite the Treasury Department's and President Reagan's analysis, Congress repealed the state and local general sales tax deduction but maintained the other aspects of the SALT deduction.[90] The Joint Committee on Taxation explained that it maintained the bulk of the SALT deduction because, although the SALT deduction favors higher-income taxpayers on its face, it indirectly benefits lower-income taxpayers through increased social services that advance general welfare (i.e., the SALT deduction increases states' funds, which can then be used to increase the public services they provide).[91] In the same vein, the Committee pointed out that the Treasury Department's and President's proposals kept most itemized deductions, and because those also generally favor high-income taxpayers, keeping the SALT deduction was not substantially different.[92] And although the

84. *Id.* at 7–8.
85. *Id.*
86. *Id.* at 8.
87. Surane, *supra* note 53, at 8.
88. *Id.*
89. *Id.*
90. *Id.* at 8–9 (citing JOINT COMM. ON TAXATION, TAX REFORM PROPOSALS: RATE STRUCTURE AND OTHER INDIVIDUAL INCOME TAX ISSUES at 143–146 (1985)).
91. *Id.* at 9.
92. *Id.*

deduction may be inefficient, it served as a better subsidy to mitigate a double tax than no measure at all.[93] The Joint Committee on Taxation then rebutted President Reagan's claim that taxpayers could relocate to jurisdictions with lower tax rates, arguing that this was "impractical and costly."[94] Finally, it concluded that "the tax system should only reach an individual's disposable income," and disallowing the SALT deduction would tax income that had already been taxed (and thus is not disposable).[95]

Congress provided its own reasons for repealing the deduction for state and local sales taxes;[96] namely, to achieve consistency, fairness, and simplicity.[97] For consistency, Congress explained that not all consumptions were deductible, so repealing the deduction remedied this discrepancy.[98] For fairness, it stated that because sales taxes were incurred when taxpayers voluntarily purchased items, "the deduction favored taxpayers with particular consumption patterns."[99] For simplicity, Congress described how "the sales tax deduction involved substantial recordkeeping and computational burdens."[100] Lastly, Congress reasoned that because this deduction represented a small portion of itemized deductions, repealing it would not drastically reduce state and local governments' revenue sources.[101]

Importantly, when faced with accusations that it promoted inequity from states with no state income tax, Congress passed a bill in 2004 allowing taxpayers to elect for a general sales tax deduction instead of a state and local income tax deduction.[102] At the time, "[t]he repeal of the general sales tax was . . . seen as a huge inequity in the Internal Revenue Code."[103] Some states had no state or local income taxes and instead relied on a relatively high sales tax for revenue.[104] As a result of these tax schemes and the lack of a general sales SALT deduction, taxpayers in those states were effectively barred from receiving the

93. Surane, *supra* note 53, at 9.
94. *Id.*
95. *Id.*
96. *Id.*
97. *Id.*
98. *Id.*
99. Surane, *supra* note 53, at 9.
100. *Id.* (citing S. REP. NO. 99-313 at 56–57 (2011)).
101. Surane, *supra* note 53, at 9.
102. *Id.* at 10 (citing American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, 1520 (2004)).
103. *Id.*
104. *Id.*

deduction.[105] By allowing taxpayers to deduct state and local sales taxes instead of income taxes, Congress provided for more equitable treatment of taxpayers living in states with different revenue sources.[106]

C. The Tax Cuts and Jobs Act of 2017

Congress's passage of the Tax Cuts and Jobs Act of 2017 constituted "the most sweeping reform of the Code since the Tax Reform Act of 1986."[107] But unlike the Tax Reform Act of 1986, the TCJA passed with only the support of the Republican Party.[108] And whereas the Tax Reform Act of 1986 narrowed the SALT deduction by eliminating the deduction of a single category of taxes, the TCJA more stringently restricted the SALT deduction by limiting the dollar-value of the deduction that could be taken under the SALT deduction.[109] With the $10,000 cap introduced by the TCJA, "only about a tenth of taxpayers [are] able to derive *any* benefit from the deduction for state and local taxes," and the benefit that those taxpayers do derive is severely limited.[110]

Critics of the law have argued that the provisions within the TCJA do not accomplish "Congress's three stated policy goals: fairness, simplicity, and tax cuts."[111] These goals were laid out in the press release of the "Unified Framework for Fixing Our Broken Tax Code," (Unified Framework) a framework created by the Trump administration, the House Committee on Ways and Means, and the Senate Committee on Finance.[112] The Unified Framework provided the following five goals for Congress to follow "to achieve pro-American, fiscally-responsible tax reform" in its legislation:

> [1] Tax relief for middle-class families. [2] The simplicity of "postcard" tax filing for the vast majority of Americans. [3] Tax relief for businesses, especially small businesses. [4] Ending incentives to

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105. *See id.* ("For instance, Texas had no income tax but a relatively high sales tax that taxpayers did not get to deduct from their federal income taxes.").

106. *Id.*

107. Stephen J. Pieklik et al., *Deducting Success: Congressional Policy Goals and the Tax Cuts and Jobs Act of 2019*, 16 PITT. TAX REV. 1, 2 (2018).

108. *Id.* at 2–3.

109. *See* Hemel, *supra* note 54, at 155 ("The 2017 Act places the most stringent limits on the SALT deduction yet . . . . The new $10,000 limit applies only to state and local property, income, and sales taxes . . . .").

110. *Id.* at 151 (emphasis added).

111. Pieklik et al., *supra* note 107, at 1.

112. *Id.* at 6–7 (citing Press Release, U.S. Dep't of the Treasury, Unified Framework for Fixing Our Broken Tax Code (Sept. 27, 2017), https://www.treasury.gov/press-center/press-releases/Pages/sm0166.aspx).

> ship jobs, capital, and tax revenue overseas. [5] Broadening the tax base and providing greater fairness for all Americans by closing special interest tax breaks and loopholes.[113]

This Unified Framework, along with other statements by Republican congressmen and members of the Trump administration, made it clear that the broad objectives of tax reform were "to make the Code fairer, simplify taxation, and reduce taxation for all Americans, particularly for the middle class and small businesses."[114]

But even though Congress opted for a less severe restriction than the full repeal of the SALT deduction called for by the Unified Framework,[115] critics still contended that the $10,000 SALT deduction cap that appeared in the final TCJA undermined the goal of fairer taxes.[116] The $10,000 cap represented "the biggest change to itemized deductions," with state legislatures and commentators viewing the limitation as "an attack on states with high taxes on the East and West Coasts."[117] This was demonstrated by the fact that eleven of the twelve Republican House members who voted against the TCJA were from California, New York or New Jersey—states with some of the highest state tax rates.[118]

Opposition is even stronger among the Democratic "[l]egislators of high-tax blue states [who] have viewed the ceiling as little short of a congressional declaration of war on blue states."[119] Representative Alan Lowenthal, a Democrat from California, expressed this opposition to the SALT deduction cap.[120] Representative Lowenthal stated:

> Mr. Speaker, I want to quote from one of my colleagues from California: "Eliminating the State and local tax deduction would

113. Press Release, U.S. Dep't of the Treasury, Unified Framework for Fixing Our Broken Tax Code at 2 (Sept. 27, 2017), https://www.treasury.gov/press-center/press-releases/Pages/sm0166.aspx (click on the hyperlink "The full framework can be found HERE" to access the framework document).

114. Pieklik et al., *supra* note 107, at 8.

115. Hemel, *supra* note 54, at 155.

116. Pieklik et al., *supra* note 107, at 1.

117. *Id.* at 15.

118. *Id.*

119. Zelenak, *supra* note 34.

120. *See* William Hays Weissman, *SALT Tastes Sour in Blue States*, TAX NOTES (Apr. 20, 2018), https://www.taxnotes.com/exempt-organizations/charitable-giving/salt-tastes-sour-blue-states/2018/04/20/27x2n (citing 163 CONG. REC. 9,588–05 (Dec. 1, 2017) (statement of Rep. Alan Lowenthal)) (providing an excerpt of Representative Alan Lowenthal's argument, which included a quote from Representative Darrell Issa, a Republican representative of California, that also denounced the elimination of the SALT deduction).

> assure that almost all of the bill's tax cuts would be distributed to other States, leaving California with the bill." That was from my Republican colleague, Darrell Issa. Mr. Speaker, he was right on this. The Republican tax plan is cruel in so many ways. But perhaps the worst provision specifically targets States like California, New York, and New Jersey. Our States have stepped into the breach left by the Federal Government. We have raised taxes to pay for infrastructure. We have raised taxes to pay for hospitals. We have raised taxes to pay for schools. Now the Republicans want to punish us? Mr. Speaker, this is a political game, plain and simple.[121]

Representative Jared Huffman, also from California, further argued that "the winners in this tax scam are the country's wealthiest . . . . Meanwhile, students, middle class families, homeowners, and seniors across this country are the losers."[122] He stressed that "Californians get an especially raw deal because [his] Republican colleagues want to impose an unfair double tax on the State and local taxes that [Californians] pay."[123] This view that the SALT deduction cap is unfair could also partially explain why Republicans were unable to acquire the necessary sixty votes to end debate in the Senate and instead resorted to budget reconciliation[124] to pass the TCJA (which requires only a simple majority).[125]

The legislative history of the SALT deduction, the TCJA, and the SALT cap reflects the ongoing debate regarding the fairness of the provision. There are arguments that the SALT deduction primarily benefits high-income taxpayers, erodes the tax base, and consequently causes higher marginal tax rates.[126] But eliminating or limiting the deduction raises the question of whether it is fair for the same income to be double or even triple taxed—to be "taxed by the locality, the state, and the federal government."[127] It also raises the question of whether

121. 163 CONG. REC. 9,588–05 (Dec. 1, 2017) (statement of Rep. Alan Lowenthal).

122. 163 CONG. REC. 9,588–02 (Dec. 1, 2017) (statement of Rep. Jared Huffman).

123. *Id.*

124. Budget reconciliation refers to bills containing changes to spending or revenues that receive "a fast-track process for consideration of bills to implement the policy choices embodied in the annual congressional budget resolution." Part of this fast-track is requiring only a simple majority of votes to pass a bill, as opposed to the regular 60 requisite votes. House Budget Comm. Staff, *Budget Reconciliation: The Basics*, HOUSE COMM. ON THE BUDGET (Aug. 11, 2021), https://budget.house.gov/sites/democrats.budget.house.gov/files/documents/Budget%20Reconciliation%20The%20Basics%20-%20Final%202021.pdf.

125. *See* Pieklik et al., *supra* note 107, at 9 ("Ultimately, because Republicans did not have sixty votes in the Senate to end debate . . . the Republicans used budget reconciliation to pass the Tax Cuts and Jobs Act, a process that allowed them to pass the bill with a simple majority.").

126. Surane, *supra* note 53, at 7–8.

127. Weissman, *supra* note 120.

it is fair for a citizen of a higher-taxed state to subsidize a citizen of a lower-taxed state through federal taxes.[128] These concerns have led state legislatures to develop workarounds to the SALT cap.[129]

II. THE TREATMENT OF SALT CAP WORKAROUNDS

Following Congress's imposition of the $10,000 cap on SALT deductions, "[d]ifferent states have turned to different strategies" to "enable their residents to thwart the intended effect of the ceiling."[130] Such strategies have included: (1) laws allowing taxpayers to convert taxes to charitable contributions (which are deductible) by "donating" to state and local government organizations in exchange for a tax credit, (2) laws allowing employers to pay payroll taxes, reducing the amount of state and local income taxes employees subsequently have to pay, and (3) the pass-through entity workaround.[131] Although this Note focuses on the PTE workaround, comparing the PTE workaround to the other two workarounds—and the IRS's treatment of them—can provide insight as to whether the Treasury Department and the IRS will, or should, issue regulations that confirm the validity of PTE workaround legislation.

A. Charitable Contribution Workaround

The charitable contribution workaround was an early attempt to circumvent the $10,000 SALT cap.[132] Although the exact mechanics of each state's legislation varied,[133] broadly speaking, the charitable contribution workaround allowed taxpayers to "contribute money to SALT-run funds used for state and local government purposes" and then to "receive credits against their state and local taxes."[134] The intended effect was that taxpayers could deduct their "donations" to the SALT funds from their federal income tax and use the resulting tax

128. *Id.*
129. Zelenak, *supra* note 34.
130. *Id.*
131. Hemel, *supra* note 54, at 171–172.
132. Zelenak, *supra* note 34.
133. *See id.* (discussing New Jersey, New York, and California's charitable contributions and the different percent credit available).
134. Brian Newman, *SALT workaround: Treasury provides safe harbors in latest regulations*, COHNREZNICK (Aug. 14, 2020), https://www.cohnreznick.com/insights/salt-cap-workarounds-treasury-regulations-provide-safe-harbors#:~:text=Under%20these%20workarounds%2C%20taxpayers%20could,their%20state%20and%20local%20taxes.

credit to offset their state and local taxes by the amount donated.[135] This allowed taxpayers to pay their state and local taxes through contributions that were fully deductible from their federal income, serving as a complete workaround to the $10,000 cap.[136]

For example, suppose that Taxpayer A lives in State X,[137] which has enacted legislation enabling a charitable contribution workaround. And suppose that Taxpayer A has $100,000 in federal taxable income and owes $30,000 in state and local taxes. To avoid the $10,000 limit on SALT deductions, Taxpayer A chooses to "donate" $30,000 to one of State X's SALT funds. In return, State X gives Taxpayer A a tax credit worth $30,000. When it is time for Taxpayer A to pay her taxes, she applies her $30,000 tax credit to her state and local taxes and deducts her $30,000 contribution from her $100,000 of federal taxable income. As a result, Taxpayer A's taxable federal income is reduced from $100,000 to $70,000, and the $30,000 she owes in state and local taxes is wiped out by the credit she received. Without the workaround in place, Taxpayer A would only be able to deduct $10,000 of state and local taxes from her federal income. By converting taxpayers' state and local taxes into a charitable contribution, this workaround entirely evades the $10,000 SALT cap and reduces taxpayers' tax liability. [138]

But the efficacy of this strategy was short-lived—on May 23, 2018, the IRS and the Treasury Department issued Notice 2018-54.[139] The Notice stated that "[d]espite these state efforts to circumvent the new statutory limitation on state and local tax deductions, taxpayers should be mindful that federal law controls the proper characterization of payments for federal income tax purposes."[140] Further, the Notice provided that "[t]he proposed regulations will make clear that the requirements of the Internal Revenue Code, *informed by substance-over-form principles*, govern the federal income tax treatment of such transfers."[141] The IRS uses substance over form principles "to reclassify a tax-motivated arrangement consistent with its substance, rather than its form."[142] By warning taxpayers that federal tax law and the

135. *Id.*
136. *Id.*
137. The mechanics of the workaround in this example are simplified and do not accurately reflect any particular state's legislation.
138. *Id.*
139. I.R.S. News Release IR-2018-122 (May 23, 2018).
140. I.R.S. Notice 2018-54 IRB 750 (May 23, 2018).
141. *Id.* (emphasis added).
142. Jaye A. Calhoun & Kernan A. Hand, *Substance-Over-Form Doctrine*, 64 LA. B.J. 461, 461 (2017).

substance over form doctrine would govern the charitable contribution workaround, the Notice suggested that this workaround would not be permitted.[143]

But when the Treasury Department issued final regulations on the charitable contribution workaround, it instead relied on the *quid pro quo* principle.[144] Simply put, the *quid pro quo* principle provides that when donors receive goods or services in exchange for their donations, the fair market value of those goods and services cannot be deducted from the donors' taxes.[145] In the final regulations, the Treasury Department explained that "[t]he *quid pro quo* principle is applicable to contributions made to *all* types of donee entities," including those controlled by state or local governments.[146] Accordingly, the Treasury Department established that "tax laws and sound tax policy support the treatment of a state tax credit as a return benefit that reduces the amount of the taxpayer's charitable contribution deduction."[147]

The Treasury Department's and IRS's decision to curb the tax benefit of the charitable contribution deduction does not necessarily imply that pass-through entity workaround legislation should be countermanded. In addressing the charitable contribution deduction, the Treasury Department carefully emphasized that it did so by utilizing the *quid pro quo* principle—not the substance over form doctrine.[148] The Treasury Department explained that although charitable contributions to local or state government organizations may appear to be taxable in substance, applying the substance over form doctrine to this workaround "raises additional issues and finds less support under other substance over form authorities."[149] More

143. Sally P. Schreiber, *IRS to clarify rules on payments in lieu of state and local taxes*, J. OF ACCOUNTANCY (May 23, 2018), https://www.journalofaccountancy.com/news/2018/may/irs-rules-payments-in-lieu-of-state-local-taxes-201819049.html.

144. *See* Treas. Reg. § 170A-1 (2019) ("The Treasury Department and the IRS have considered the substance over form doctrine . . . but have ultimately decided that, as a general matter, the application of the *quid pro quo* principle provides a more sound, comprehensive, and administrable approach.").

145. *See* Allison Gauss, *What You Need to Know About Quid Pro Quo Donations*, CLASSY, https://www.classy.org/blog/what-you-need-to-know-about-quid-pro-quo-donations/ (last visited Mar. 1, 2022).

146. Treas. Reg. § 170A-1 (2019).

147. *Id.*

148. *See id.* ("The Treasury Department and the IRS have considered the substance over form doctrine in analyzing the proper tax treatment of contributions in exchange for tax credits, but have ultimately decided that, as a general matter, the application of the *quid pro quo* principle provides a more sound, comprehensive, and administrable approach.").

149. *Id.*

specifically, the Treasury Department stated that doing so "would result in the significant expansion in the definition of 'tax'. . . , would raise questions involving the proper timing of deductions for such payments, and would result in different treatments for similarly situated taxpayers."[150]

Not only would a substance over form approach raise additional issues, but such an approach would also "not fully address concerns raised by commenters [on the proposed regulations] regarding state and local tax credit programs."[151] This is because the charitable contribution workaround can "generate tax benefits in excess of the amount the taxpayer contributes to the charitable organization, regardless of whether the contribution is made to an entity controlled by a state or local government."[152]

The Treasury Department's and IRS's decision to apply the *quid pro quo* principle instead of the substance over form doctrine is significant; although the substance over form doctrine can be applied to the PTE workaround,[153] the *quid pro quo* doctrine only applies to charitable contributions—in other words, it cannot be used to rebut the PTE workaround.[154] Accordingly, the Treasury Department's method of stifling the charitable contribution workaround does not provide an analogous method of regulating the PTE workaround.

But the Treasury Department's logic in rejecting the use of substance over form principles in this context likely cannot be extended to rejecting the use of the substance over form principles in the context of the PTE workaround. In rejecting the use of the substance over form doctrine, the Treasury Department and the IRS cited issues specific to the charitable contribution workaround.[155] Moreover, the Treasury Department and the IRS noted that

150. *Id.*

151. *Id.*

152. *Id.*

153. *See* Andrew Roberson & Kevin Spencer, *Ninth Circuit Holds Tax Form is Substance*, JD SUPRA (June 4, 2021), https://www.jdsupra.com/legalnews/ninth-circuit-holds-tax-form-is-7130998/ ("The substance over form doctrine . . . [is] often invoked by courts to disallow tax consequences that seem too good to be true.").

154. *See Charitable Contributions – Quid Pro Quo Contributions*, IRS, https://www.irs.gov/charities-non-profits/charitable-organizations/charitable-contributions-quid-pro-quo-contributions ("[A quid pro quo contribution] is a payment a donor makes *to a charity* partly as a contribution and partly for goods or services.") (Aug. 1, 2022) (emphasis added).

155. *See* Treas. Reg. § 170A-1 (2019) (providing the Treasury Department and IRS's concerns about the substance over form approach in fully addressing contributions to charitable organizations and the practicability of providing criteria to distinguish between state and local government entities and section 170(c)(2) organizations).

"application of the *quid pro quo* principle provides a *more* sound, comprehensive, and administrable approach."[156] This does not necessarily imply that application of the substance over form doctrine would not be sound, comprehensive, and administrable—it just would not be as narrowly tailored and directly applicable as the *quid pro quo* principle is in the specific context of charitable contributions. Therefore, although the Treasury Department and the IRS's approach to closing the charitable contribution workaround does not provide analogous reasoning for rejecting the PTE workaround, it also does not necessarily preclude applying the substance over form doctrine to the PTE workaround.

B. Payroll Tax Workaround

Another legislative attempt to circumvent the $10,000 SALT cap came in the form of a payroll tax.[157] The payroll tax workaround was first introduced in 2018 by the New York legislature in the Employer Compensation Expense Program, which provides for a "voluntary tax on employers based upon the wages paid to employees in excess of $40,000 per year."[158] The employer can elect to participate in the program and thereafter "pay tax . . . on the wages of all employees in excess of $40,000 and include the Payroll Tax remittance with the withholding tax filings."[159] The tax ranges from 1.5 percent for 2019 to 3 percent for 2020 to 5 percent for 2021 and beyond.[160] The employee then receives "a credit for the amount of tax paid by the employer on his/her salary thereby reducing the New York State and local income tax."[161]

Although employees are still subject to the SALT cap, this credit reduces their state income tax liability.[162] And because many taxpayers have SALT taxes "far in excess of the $10,000 limitation . . . the relief provided by the Payroll Tax could be significant."[163] Similar to other workarounds' shifting of income taxes to categories of taxes that are

156. *Id.* (emphasis added).
157. Glenn Neman & Marvin A. Kirsner, *NY Enacts Payroll Tax Law in Response to Federal SALT Deduction Limitation*, GREENBERG TRAURIG, LLP (Apr. 5, 2018), https://www.gtlaw.com/en/insights/2018/4/ny-enacts-payroll-tax-law-in-response-to-federal-salt-deduction-limitation.
158. *Id.*
159. *Id.* (emphasis omitted).
160. *Id.*
161. *Id.*
162. Berg, *supra* note 52, at 464.
163. Neman & Kirsner, *supra* note 157

not subject to the SALT cap, the payroll tax workaround shifts the tax from the employees' income to the employer's revenue (which the employer can then deduct as a business expense).[164] Accordingly, this workaround decreases taxpayers' state income tax burden while maintaining the state's revenue.[165] The following example demonstrates the extent of an individual taxpayer's federal tax savings resulting from the payroll tax workaround:

> [A]n employer electing to participate in the program for 2019 would pay $15,000 of tax for an employee with wages of $1,040,000 per year (the amount in excess of $40,000 x [1.5] percent). The $15,000 paid by the employer would be available to reduce the employee's state and local income tax by $15,000, saving the federal tax on that amount . . . . Then the employee's salary could be reduced by $15,000 for a net compensation of $1,025,000. [I]n 2021, the employer would pay $50,000, with that amount available as a credit reducing their state and local income tax . . . . The federal tax savings would range from $5,550 for 2019; [to] $18,500 in 2021 in this example.[166]

Unlike the charitable contribution workaround, however, the IRS has not directly addressed this workaround.[167] And "it is less likely that the IRS *will* intervene."[168] This can be attributed to the fact that the payroll tax workaround depends "completely upon employer participation,"[169] and large employers are generally not participating in the payroll tax program.[170]

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164. *See* Berg, *supra* note 52, at 464 ("The payroll tax option keeps state revenue flat by simply shifting the state tax incidence from the employee to the employer and facilitates a full deduction of state income tax paid at the federal level . . . . Because a payroll tax is incurred in carrying on a trade or business, an employer can deduct the full value paid under Section 162.").

165. *Id.* at 465–66.

166. Neman & Kirsner, *supra* note 157.

167. *See* Jeffrey S. Reed, *Potential IRS Challenges to SALD Deduction Limitation Workarounds*, J. OF MULTISTATE TAX'N 39, 39 (2018), ("Notice 2018-54 focuses on the charitable contribution workaround, not the payroll tax, so it is at least possible that the IRS would not challenge the [deductibility of] payroll tax deductions taken by employers.").

168. Frank Sammartino, *How New York State Responded to the SALT Deduction Limit*, TAX POL'Y CTR., https://www.taxpolicycenter.org/taxvox/how-new-york-state-responded-salt-deduction-limit (May 21, 2018) (emphasis added).

169. Carmella R. Campisano, *SALT In the Wounds: Issue and Solutions Surrounding the TCJA SALT Deduction Cap*, 50 SETON HALL L. REV. 525, 541 (2019) (citing Richard Rubin & Mike Vielkind, *New York Found a Fix for Some Hit by Tax Law. Employers are Skeptical*, WALL ST. J. (May 2, 2018, 5:30 AM), https://www.wsj.com/articles/companies-skeptical-of-new-yorks-creative-workaround-for-tax-deduction-caps-1525253401.).

170. Sammartino, *supra* note 168.

Employers have not opted into this payroll tax for several reasons.[171] First, effectively explaining the complex workaround to employees has proven to be difficult.[172] The payroll tax workaround "would likely reduce wages[,] but workers would receive a tax credit to compensate them for any decline in their take-home pay resulting from the new payroll tax."[173] So, to implement the program, the employer must convince employees that they will be better off financially, despite receiving lower wages, once they account for taxes.[174] This is no easy task, and employees' concerns regarding receiving lower wages are not unfounded—pre-tax income "determines Social Security benefits and can affect 401(k) matching contributions, employees' share of health-care premiums and the starting point for job negotiations."[175]

Additionally, introducing the payroll tax scheme at the state level raises concerns about the parity of employee wages for employers who operate in multiple states.[176] If a New York employer opted for the payroll tax, then its employees who work in other states would still receive the lower wages associated with the workaround, but they "would not receive a corresponding credit or exclusion to make up the difference in their state of residence."[177] This same issue would arise for employees that work in New York but are not residents of New York (e.g., employees commuting from Connecticut or New Jersey).[178]

Like the charitable contribution workaround, the payroll tax workaround can be distinguished from the pass-through entity workaround. The payroll tax workaround has been largely passed over by businesses,[179] and the Treasury Department and IRS have yet to indicate that they will issue regulations regarding it.[180] On the other hand, many businesses are taking advantage of the PTE workaround,[181]

171. Reed, *supra* note 167, at 39.
172. *Id.*
173. Sammartino, *supra* note 168.
174. Reed, *supra* note 167, at 39.
175. Rubin & Vielkind, *supra* note 169.
176. *See id.* ("At the same time, there are concerns about how the Treasury and IRS will look at [the payroll tax provisions] and what happens if you have employees in other states . . . . Smaller businesses . . . might be more likely to participate, because they're less likely to encounter the same challenges with employee communications and parity with employees in other states.").
177. Reed, *supra* note 167, at 39.
178. *Id.*
179. Rubin & Vielkind, *supra* note 169.
180. *See* Reed, *supra* note 167, at 39.
181. *See* Rubin & Vielkind, *supra* note 1 ("Nearly 96,000 filers used the program."); Sobel, *supra* note 2 (explaining the New Jersey business owners saved over $500 million in taxes due to the state's SALT workaround for pass-through entities); Danesh, *supra* note 3 ("[M]ore than

and the IRS *has* explicitly provided that it will issue regulations regarding state-level legislation enabling the PTE workaround.[182] Moreover, businesses have not used the payroll tax workaround in part due to the lack of incentives that employers have to participate.[183] But unlike the payroll tax workaround, the PTE workaround does not rely on unincentivized employer participation—instead, pass-through entity owners are aiming to reduce their own tax liability.[184] Accordingly, although it has been over two years since the Treasury Department and IRS issued the Notice regarding the PTE workaround, their inaction in issuing regulations for the payroll tax workaround does not suggest that they will similarly abstain from issuing regulations governing the legal viability of the PTE workaround.

C. *Pass-Through Entity Workaround*

The Treasury Department's and IRS's Notice providing for forthcoming regulations that will explicitly permit state legislation enabling the PTE workaround still leaves room for "concern among tax professionals that the IRS may still reverse course and issue regulations or other guidance less favorable to these state SALT cap workarounds."[185] Although Notice 2020-75 is clear that partnerships and S corporations (i.e., pass-through entities) are allowed a deduction for "any amount paid by a partnership or an S corporation to a State . . . to satisfy its liability for income taxes imposed by the [state],"[186] taxpayers should not completely rely on this Notice.

As a general matter, "notices are not controlling legal authority," and "[t]o have the force and effect of binding law, the Treasury must issue the same content in a regulation."[187] Therefore, although notices may "represent the IRS's opinion as to how tax laws should apply to subject transactions," and can accordingly provide guidance to

400,000 Illinois businesses will benefit from the new [PTE workaround] law.").

182. I.R.S. Notice 2020-75, I.R.B. 1453 (Nov. 9, 2020).

183. Campisano, *supra* note 169, at 541.

184. *See* Dawson & Shaikh, *supra* note 43 (describing how pass-through entity owners use the PTE workaround to reduce their own tax liability); Campisano, *supra* note 169, at 541 ("This may be because [New York's payroll tax workaround legislation] offers no real incentive to participate.").

185. Tony Konkol & Catherine Stanton, *The Growing Trend of Pass-Through Entity SALT Cap Workarounds*, CHERRY BEKAERT (Nov. 3, 2021), https://www.cbh.com/guide/articles/pass-through-entity-salt-cap-workarounds-2021-guidance/.

186. I.R.S. Notice 2020-75, 2020-49 I.R.B. 1453 (Nov. 9, 2020).

187. Andrea Kramer, *The Legal Effect of IRS Pronouncements on Virtual Currency*, JD SUPRA (June 3, 2020), https://www.jdsupra.com/legalnews/the-legal-effect-of-irs-pronouncements-25516/.

taxpayers, regulations issued by the Treasury Department supersede them.[188] Importantly, "[t]he Secretary of the Treasury is responsible for formulating and recommending . . . tax polic[ies]," and "[t]he Deputy Secretary plays a primary role in the formulation and execution of Treasury policies and programs."[189] And since the Trump administration issued the PTE workaround Notice on November 9, 2020,[190] both the Treasury Secretary and the Deputy Treasury Secretary have changed under the Biden administration.[191] Further, the IRS Commissioner, who "presides over the nation's tax system,"[192] had a term that ended in November 2022,[193] with a different IRS official leading the agency on an interim basis until the Biden administration formally replaces him.[194] Thus, changes in both the Presidency and the Treasury Department leadership could lead to the Treasury Department issuing final regulations that overrule the Notice's stance. It is therefore important to examine the policy implications of allowing or disallowing the PTE workaround.

III. POLICY CONSIDERATIONS FOR THE PTE WORKAROUND

The SALT deduction—particularly the $10,000 cap and PTE workaround —introduces a wide range of conflicting public policy implications, providing legislators with unique challenges from a policy perspective. This Part examines arguments relating to both generally

188. *Id.*

189. *Duties and Functions FAQs*, U.S. DEP'T OF THE TREASURY, https://home.treasury.gov/subfooter/faqs/duties-and-functionsfaqs#:~:text=The%20Secretary%20of%20the%20Treasury%20is%20responsible%20for%20formulating%20and,and%20managing%20the%20public%20debt (last visited Mar. 13, 2022).

190. I.R.S. Notice 2020-75, 2020-49 I.R.B. 1453 (Nov. 9, 2020).

191. Martha C. White, *Janet Yellen Confirmed as First Female Treasury Secretary in U.S. History*, NBC NEWS (Jan. 25, 2021, 6:28 PM), https://www.nbcnews.com/business/economy/janet-yellen-confirmed-first-female-treasury-secretary-u-s-history-n1255595; Sylvan Lane, *Senate Confirms Adeyemo as Deputy Treasury Secretary*, THE HILL (Mar. 25, 2021, 4:25 PM), https://thehill.com/policy/finance/544982-senate-confirms-adeyemo-as-deputy-treasury-secretary.

192. *See Commissioner Charles P. Rettig*, IRS (Nov. 23, 2021), https://www.irs.gov/newsroom/commissioner-charles-p-rettig#:~:text=in%20the%20News-,Charles%20P.,receipts%20of%20the%20United%20States ("As Commissioner, Mr. Rettig presides over the nation's tax system . . . .").

193. Jeff Stein, *Trump's Pick for IRS Chief is Now Faced with Implementing Biden's Economic Agenda*, WASH. POST (May 19, 2021, 1:22 PM), https://www.washingtonpost.com/us-policy/2021/05/19/charles-rettig-irs-trump-biden/.

194. Jacob Bogage, *Biden to Replace IRS Commissioner as Democrats Seek to Retool Tax Agency*, WASH. POST (Oct. 28, 2022, 5:17 PM), https://www.washingtonpost.com/us-policy/2022/10/28/biden-irs-commissioner/.

increasing and decreasing the SALT cap, as well as specifically allowing the PTE workaround. Because the PTE workaround serves as a mechanism to increase the amount taxpayers can deduct under the SALT deduction, certain reasoning supporting increasing the SALT cap can be extended to support allowing the PTE workaround. Conversely, arguments that the SALT cap should be restricted (or that the SALT deduction should be eliminated altogether) can be extended to arguments against the PTE workaround.

Republicans generally view the cap as a subsidy for blue states' progressive benefits that result from their (generally) higher state taxes.[195] But from Democrats' viewpoint, the issue is not as clean cut—although raising the cap would reverse the tax hikes in blue states caused by the TCJA, doing so would also disproportionately benefit wealthy taxpayers.[196] This Section aims to outline and evaluate the various policy implications of allowing or disallowing the deduction which may be guiding the Treasury Department's and IRS's deliberations in issuing regulations.

A. The Democratic Divide

Easing restrictions on the SALT cap "leaves Democrats in a damned-if-they-do, damned-if-they-don't bind."[197] On one hand, the $10,000 cap essentially increases taxes in blue states, and easing restrictions on workarounds would help those states.[198] On the other hand, mitigating the effect of the SALT cap disproportionately benefits high-income taxpayers—a direct contradiction of Democrats' typical "make-the-rich-pay-their-fair-share political messaging."[199] This divide demonstrates how the SALT cap is "a rich-person-in-a-blue-state problem," and this marks the root of disagreement between Democrats.[200]

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195. Vesoulis, *supra* note 9.

196. *Id.*

197. *See id.* ("The standoff leaves Democrats in a damned-if-they-do, damned-if-they-don't bind: deliver a windfall to wealthy Americans or screw over Democratic states on the eve of a midterm election where Democrats' narrow majorities in both chambers are at risk.").

198. *Id.*

199. *See id.* ("Whatever form the provision ends up taking could have . . . significant political fall-out for the party's make-the-rich-pay-their-fair-share political messaging. That's because raising the cap on SALT deductions from $10,000 to $80,000, as prescribed in the House-passed version of BBB, would disproportionately help taxpayers rich enough to benefit from itemizing their federal tax deductions . . . .").

200. *See* Josephson, *supra* note 14 ("It's probably more accurate to say [that the SALT deduction is] a rich-person-in-a-blue-state problem.").

Democrats that support increasing SALT deductions largely do so because the $10,000 cap "mean[s] that residents in higher-tax states like New York and New Jersey [can] no longer deduct the full value of their state tax obligation from their federal bill."[201] And these high-tax states tend to be Democratic states.[202] United States Representative Thomas Suozzi of New York argues that Democratic states "need to have this state and local tax deduction" because they have "built a whole system around it."[203] Moreover, he explains that Democratic states need a full SALT deduction because they are "in a competition with states that do not insure their children, do not pay their teachers, do not have mass transit and think that climate change is a hoax . . . . And as a result, their costs are cheaper."[204] Essentially, the argument is that high-tax blue states need a higher SALT deduction allowance for their residents to receive the full public benefits the state provides without facing higher federal tax liability as a result.

Further, the inability of high-income taxpayers in these states to fully deduct their state and local taxes could have the side effect of driving these taxpayers—and the revenue generated from their tax payments—out of these states.[205] And in turn, this would ultimately reduce these states' revenue, which would "gut their ability to provide robust social policies."[206] Although the Joint Committee on Taxation rebutted President Reagan's argument that taxpayers can move to jurisdictions with lower tax rates as "impractical and costly,"[207] here, Democrats are referring to high-income taxpayers, who could more likely afford such an option. This negative externality could also quash coastal blue states' ability to act as "laboratories for democracy" by testing progressive policies prior to enacting them under federal law.[208] It is important to note, however, that "most comprehensive research suggests that it is very rare for high-income people to move across state lines for tax reasons and that very wealthy individuals generally

201. Thomas Franck, *Moderate Democrats Want the $3.5 Trillion Spending Plan to Remove the Limit on State and Local Tax Deductions*, CNBC, https://www.cnbc.com/2021/09/08/moderate-democrats-want-biden-spending-plan-to-eliminate-salt-cap.html (Sept. 8, 2021, 5:05 PM).

202. *See* Vesoulis, *supra* note 9 ("[T]he main losers of the new $10,000 SALT deduction cap were well-to-do people in states with the highest property taxes—Democratic states, like California, New York and New Jersey.").

203. Franck, *supra* note 201 (quoting Representative Thomas Suozzi).

204. *Id.* (quoting Representative Thomas Suozzi).

205. Vesoulis, *supra* note 9.

206. *Id.*

207. Surane, *supra* note 53, at 9.

208. Vesoulis, *supra* note 9.

relocate less frequently than other people."[209] This implies that although frequently cited, in reality, this argument does not carry much weight.

Another common argument by Democrats who support raising the SALT cap is that middle-class wage-earners who live in metropolitan areas with high costs of living (e.g., Hoboken, New Jersey) would also benefit from an increased cap.[210] Because a large proportion of these middle-class wage-earners' salaries are spent on living expenses, the SALT deduction also benefits them.[211] Essentially, this argument boils down to the fact that middle-class individuals living in big metropolitan centers earn higher wages to pay for the higher costs of living, whereas their middle-class counterparts living in areas with lower costs of living correspondingly earn lower wages.[212] Remember that the SALT deduction disproportionately benefits higher-income taxpayers, whereas the SALT cap disproportionately punishes higher-income individuals.[213] For example, the $10,000 SALT cap allows for a higher proportion of taxes to be deducted for a taxpayer who would otherwise owe $20,000 in income taxes than an individual who would otherwise owe $50,000 in income taxes. Accordingly, the middle-class individuals who live in big metropolitan areas are more negatively impacted by the SALT cap than their middle-class counterparts who live in areas that have lower wages and lower costs of living, even though they may not be better off financially after accounting for costs of living. [214]

On the other hand, Democrats who oppose increasing SALT deductions primarily argue that the SALT deduction is regressive—in other words, the SALT deduction has a "steep cost and [a] heavy tilt toward wealthy individuals and profitable corporations."[215] Taxpayers

209. Steve Wamhoff et al., *Options to Reduce the Revenue Loss from Adjusting the SALT Cap*, INST. ON TAX'N & ECON. POL'Y (Aug. 26, 2021), https://itep.org/options-to-reduce-the-revenue-loss-from-adjusting-the-salt-cap/.

210. Vesoulis, *supra* note 9.

211. *Id.*

212. *See id.* ("It's a gift for middle-class wage-earners, like teachers or firefighters, who might have relatively high combined household incomes . . . but see much of their earnings wiped out by high costs of living in big metropolitan centers.").

213. *Id.*

214. *See id.* ("Our cost of living is higher [in big metropolitan centers], so our folks need to make more. They shouldn't be punished and double taxed for it. . . ").

215. Chuck Marr et al., *Repealing "SALT" Cap Would be Regressive and Proposed Offset Would Use up Needed Progressive Revenues*, CTR. ON BUDGET AND POL'Y PRIORITIES (Dec. 10, 2019), https://www.cbpp.org/research/federal-tax/repealing-salt-cap-would-be-regressive-and-proposed-offset-would-use-up-needed.

must itemize to receive a SALT deduction.[216] Thus, because higher-income taxpayers are more likely to itemize,[217] higher-income individuals are also more likely to deduct taxes under the SALT deduction. Demonstratively, if the SALT cap was fully repealed "[m]ore than half of the benefit would flow to those in the top 1 percent; over 80 percent of the benefit would flow to the top 5 percent."[218] Further, a full repeal from 2020 through 2025 would cost an estimated $600 billion.[219] Democrats such as Senator Michael Bennet argue that "[o]ur priorities should be making sure that families have affordable childcare [and] that we have paid family and medical leave and that it's meaningful . . . . [S]pending money on a regressive tax policy, like SALT . . . diminishes our ability to do those other things." [220]

Although allowing only pass-through entities to fully use the SALT deduction would likely not have as extreme of an effect as fully repealing the SALT cap for all taxpayers, it is possible that the effect would be even more regressive. Pass-through entity income skews towards the wealthy; despite the fact that "most pass-through businesses are owned by middle-income households," 71 percent of pass-through entity income is earned by the richest 1 percent of households.[221] With pass-through entity income overwhelmingly being earned by the 1 percent, allowing a workaround that benefits only pass-through entities would primarily provide tax relief for the wealthy.

The question from a Democratic perspective, then, is whether the alleged spillover effects of increased public services resulting from the SALT deduction outweight the fact that increasing SALT deductions—e.g., by allowing pass-through entities to deduct all state and local taxes—serves as a tax cut for the rich. This is also an argument that Republicans have made, condemning Democrats as seeking to provide a tax break for the wealthy via increased SALT deductions.[222]

216. Josephson, *supra* note 14.

217. Erica York, *Who Benefits from Itemized Deductions?*, TAX FOUND. (Mar. 7, 2019), https://taxfoundation.org/itemized-deduction-benefit/.

218. Marr et al., *supra* note 215.

219. *Id.*

220. Vesoulis, *supra* note 9.

221. William G. Gale & Claire Haldeman, *The Other 95%: Taxes on Pass-Through Businesses*, ECONOFACT (Apr. 22, 2021), https://econofact.org/the-other-95-taxes-on-pass-through-businesses#:~:text=While%20most%20pass%2Dthrough%20businesses,1%25%20of%20the%20income%20distribution.

222. *See* Vesoulis, *supra* note 9 ("Those [Democrats] in favor of raising the cap must, essentially, defend their decision to include a tax break for the relatively well-off in a bill that is being sold . . . as a tool to bolster the middle class. The argument leaves them wide open to attacks

B. The Republican View

The debate surrounding the SALT cap presents "surprising role reversals" between conservative Republicans and liberal Democrats.[223] Here, Republicans actually defend the SALT cap, which results in increased taxes for high-income taxpayers.[224] And although this defense may primarily be a political, offensive tactic—promoted by Republicans because the SALT cap increases federal revenue at the expense of states that are largely Democratic[225]— the overlying arguments are worth examination.

The principal argument that Republicans make against raising or eliminating the SALT cap is that the SALT deduction subsidizes blue states' social programs that are implemented through higher state taxes.[226] For example, Senator John Cornyn states that his "29 million constituents in Texas are not interested in subsidizing bad governing decisions made in places like New York or San Francisco."[227] This aligns with the Trump administration's original intent in placing the $10,000 cap on the SALT deduction: "to raise revenue to help offset the cost of tax cuts elsewhere."[228] The basic argument here is that Republicans oppose a costly deduction that primarily benefits (wealthy) Democrats.[229] Ironically, the states most affected by the SALT deduction cap are blue "donor" states[230] such as New Jersey, California, New York, and Connecticut—meaning the SALT cap effectively causes blue states to further subsidize red states that rely on federal funds.[231]

As briefly mentioned above, Republicans have also resorted to making arguments traditionally reserved for progressive Democrats

from the GOP, and Republicans are taking their cue.").

223. Barney Frank, *Republicans, Ideology, and Demise of the State and Local Tax Deduction*, THE HILL (Dec. 20, 2021, 10:30 AM), https://thehill.com/opinion/finance/586530-republicans-ideology-and-demise-of-the-state-and-local-tax-deduction.

224. *Id.*

225. *Id.*

226. Vesoulis, *supra* note 9.

227. *Id.* (quoting Senator John Cornyn).

228. Naomi Jagoda, *GOP Ramps Up Attacks on SALT Deduction Provision*, THE HILL (Dec. 2, 2021, 6:00 AM), https://thehill.com/policy/finance/583931-gop-ramps-up-attacks-on-salt-deduction-provision.

229. Vesoulis, *supra* note 9.

230. "Donor" states are "states [that] send more money to the federal government in taxes than they get back in federal spending." Milligan, *supra* note 15.

231. *See* Milligan, *supra* note 15 ("'President Carrot Head, Trump, was using the blue state money to help his donors," says Democratic Rep. Bill Pascrell, whose home state of New Jersey is affected the most by the limit in the SALT deduction former President Donald Trump signed in 2017.").

when attacking efforts to increase the amount of SALT deductions allowed.[232] Senator Pat Toomey argued that after railing against Republicans for favoring tax breaks that benefit the well-off, "with the first chance [Democrats] get, they do this huge tax giveaway to their wealthiest supporters."[233] Republicans thus continue to emphasize that increasing SALT deductions would be extremely costly to society while providing large tax cuts to the wealthy.[234]

IV. POLICY PROPOSALS: THE PTE WORKAROUND & THE SALT CAP

Guided by the substance over form doctrine and relevant policy considerations, this Note concludes that the PTE workaround should not be permitted. Thus, when the Treasury Department and IRS issue final regulations on the matter, they should overrule the allowance of state-level PTE workaround legislation that was put forth in Notice 2020-75. There can, however, be some alleviation for high-tax states and the taxpayers who reside therein while limiting the regressivity of the SALT deduction. The $10,000 SALT cap should be eliminated for taxpayers whose incomes are under a certain threshold and progressively reduced for taxpayers whose incomes exceed that threshold.

The Treasury Department and IRS should use the substance over form doctrine to deny use of state-level legislation enabling the PTE workaround. Under the substance over form doctrine, the IRS may "ignore an arrangement's legal form and examine its actual substance, with the goal of preventing artificial structures from being used to avoid paying taxes."[235] And although the state-level legislation allowing pass-through entities to pay taxes at the entity level instead of at each individuals' level may follow applicable tax law in form, in substance, it serves as a method of federal tax avoidance. Further, the Treasury Department and the IRS have already considered using the substance

232. *See* Vesoulis, *supra* note 9 ("Those [Democrats] in favor of raising the cap must, essentially, defend their decision to include a tax break for the relatively well-off in a bill that is being sold . . . as a tool to bolster the middle class. The argument leaves them wide open to attacks from the GOP, and Republicans are taking their cue.").

233. *Id.*

234. *See* Jagoda, *supra* note 228 ("Republicans established the $10,000 cap on the SALT deduction in an effort to raise revenue to help offset the cost of tax cuts elsewhere in their 2017 law . . . .").

235. *What is the Substance Over Form Doctrine?*, PALADINI LAW (Oct. 20, 2019), https://paladinilaw.com/substance-over-form/.

over form doctrine to eliminate the charitable contribution workaround.[236] Although they ultimately did not use the substance over form doctrine to bar the charitable contribution workaround, the reasons for not doing so do not extend to the pass-through entity context.[237] The Treasury Department and IRS's consideration of using the substance over form doctrine in the SALT cap workaround context indicates that applying it to the PTE workaround could be appropriate.

Moreover, the concern voiced by Republicans and progressive Democrats that increasing SALT deductions would be regressive outweighs more moderate Democrats' concern that reducing SALT deductions shifts the tax burden from the federal government to high-tax states to provide public service. And because the PTE workaround directly increases SALT deductions, allowing it is regressive. The primary issue with regressive tax schemes is that they generally contribute to inequality.[238] Preventing the rise of inequality is particularly important given the fact that "[s]ince about 1980, income inequality in the U.S. . . . has exploded."[239] And inequality is associated with "lower long-term GDP growth rates, higher crime rates, poorer public health, increased political inequality, and lower average education levels."[240] These considerations directly counter the argument that the SALT deduction cap prevents governments from providing public services.

Even assuming that eliminating the workaround and keeping the workaround are equally beneficial to society, eliminating the workaround would increase the federal tax base,[241] while allowing for it would decrease the federal tax base *and* increase marginal tax rates.[242] Essentially, the argument here is that denying the workaround not only increases the federal tax base but also prevents the social ills from

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236. Treas. Reg. § 170A-1 (2019).

237. *See supra* text accompanying notes 134–145.

238. *See* Eric Kades, *Giving Credit Where Credit is Due: Reducing Inequality with a Progressive State Tax Credit*, 77 LA. L. REV. 359, 361 (2016) ("Regressive state tax schemes gratuitously contribute to inequality.").

239. *Id.* at 365.

240. Nicholas Birdsong, *The Consequences of Economic Inequality*, SEVEN PILLARS INST. (Feb. 5, 2015), https://sevenpillarsinstitute.org/consequences-economic-inequality/#:~:text=However%2C%20the%20disadvantages%20of%20economic,and%20lower%20average%20education%20levels.

241. *See* Vesoulis, *supra* note 9 ("Those [Democrats] in favor of raising the cap must, essentially, defend their decision to include a tax break for the relatively well-off in a bill that is being sold . . . as a tool to bolster the middle class. The argument leaves them wide open to attacks from the GOP, and Republicans are taking their cue.").

242. Surane, *supra* note 53, at 7–8.

inequality that would result from permitting the workaround. On the other hand, allowing the workaround would provide funds for state and local governments to mitigate social ills, but doing so would also *decrease* the federal tax base. This demonstrates how denying the workaround serves as a more tax-dollar effective measure to prevent social ills. And preventing social ills and inequality (by eliminating the workaround) may be a more desirable outcome than causing social ills (through enforcing a regressive tax) and then remediating them (using the revenue raised by allowing the workaround).

Although there is not currently any empirical research indicating the actual cost of permitting the PTE workaround, public policy considerations and application of the substance over form doctrine weigh in favor of denying use of the workaround. Accordingly, the Treasury Department and the IRS should issue regulations invalidating state legislation that provides for a PTE workaround. Research into (1) the extent to which the PTE workaround contributes to inequality and (2) how effective states are in using the tax revenue raised by the PTE workaround to address social ills could be used to quantify these arguments and allow the Treasury Department and IRS to better weigh whether the workaround should be permitted.

Allowing workarounds that primarily benefit the rich is ultimately regressive,[243] and the arguments set forth in this Note against the PTE workaround could be extended to *any* workaround that serves to increase the amount of taxes that wealthier taxpayers can deduct. Instead of allowing state legislatures to continue to cycle through creative workarounds—first the charitable contribution workaround, then the payroll tax workaround, and currently the PTE workaround—which are ultimately countermanded, the federal legislature should take steps to address the root issue of the SALT deduction: its regressive nature.

It *is* possible to provide relief to high-tax states and their taxpayers while limiting the regressive nature of the SALT cap workaround. This could be done through a more progressive SALT deduction scheme that tilts the benefits of the deduction towards lower-income individuals. More progressive SALT deduction schemes have already been introduced in both the Senate and the House of Representatives.[244] In the Senate, Senator Bernie Sanders developed a

243. *See supra* text accompanying notes 215–220.

244. *See* Jeff Collins, *Porter-backed Bill Seeks to Restore SALT Deductions Capped Under*

plan to "eliminate the cap for taxpayers earning less than $400,000, while imposing some form of a cap for those earning more."[245] Along these lines, and more recently, Representatives Katie Porter and Tom Malinowski co-sponsored a similar bill in the House.[246] These proposals serve as a compromise to the House's proposed SALT cap revision, which would have increased the SALT cap to $80,000 across the board.[247]

Importantly, under this new proposal "91 percent of the benefits would go to those with [adjusted gross income] of less than $400,000."[248] This would largely reduce the regressive effect that raising the SALT cap to $80,000 for all taxpayers would have—that proposal would afford the majority of the benefit to taxpayers who make more than $475,000 per year.[249] Thus, it stands to reason that enacting a more progressive SALT cap provision—instead of continuing to allow the PTE workaround—could provide a less regressive means to mitigate lower-income taxpayers' tax burden. The Treasury Department and IRS should accordingly bar not only the PTE workaround, but also any future SALT deduction workaround that disproportionately benefits the wealthy. Future regulations and legislation should then be directed towards enacting less regressive SALT deduction schemes.

CONCLUSION

The SALT deduction has a long, contentious history. The $10,000 cap on the deduction, introduced by the Tax Cuts and Jobs Act, and the debate surrounding it exemplify the impact of tax policy on society. Further, the cap has inspired several workarounds—the latest being the pass-through entity tax. This workaround, however, is fundamentally a tax avoidance scheme with regressive tax policy implications that are

2017 Tax Act, ORANGE CNTY. REG., https://www.ocregister.com/2022/03/11/porter-backed-bill-seeks-to-restore-salt-deductions-capped-under-2017-tax-act/ (Mar. 11, 2022, 10:25 AM) ("A compromise plan backed by Sen. Bernie Sanders, like the Porter-Malinowski bill, would eliminate the cap for taxpayers earning less than $400,000, while imposing some form of a cap for those earning more.").

245. *Id.*

246. *Id.*

247. *Id.*

248. Steve Wamhoff, *Latest Proposal from Senate Democrats Would Bar the Rich from SALT Cap Relief*, INST. ON TAX'N & ECON. POL'Y (Dec. 7, 2021), https://itep.org/latest-proposal-from-senate-democrats-would-bar-the-rich-from-salt-cap-relief/.

249. *See id.* (providing a table that states taxpayers with an adjusted gross income of over $475,000 would receive 51 percent of the benefit from the $80,000-cap House Build Back Better SALT provision, while taxpayers who make under $400,000 would receive just 41 percent of the share of tax change).

costly to society. Therefore, the Treasury Department and the IRS should issue final regulations that overrule Notice 2020–75 and deny states the ability to pass PTE workaround legislation. Future attempts to alleviate the effect of the SALT cap should accordingly turn to methods that counter the regressivity of the deduction, such as the Senate's and the House's bills proposing a more progressive SALT cap.