[Florida Tax Review](https://scholarship.law.ufl.edu/ftr)

[Volume 25](https://scholarship.law.ufl.edu/ftr/vol25) [Article 7](https://scholarship.law.ufl.edu/ftr/vol25/iss1/7)

2023

Too Much SALT? The Nuanced Impact of the State and Local Tax Deduction Cap on Pass-Through Business Taxpayers

Jeffrey H. Kahn
Florida State University College of Law

Miles A. Romney
Florida State University

John S. Treu
West Virginia University

Follow this and additional works at: https://scholarship.law.ufl.edu/ftr

Recommended Citation

Kahn, Jeffrey H.; Romney, Miles A.; and Treu, John S. (2023) "Too Much SALT? The Nuanced Impact of the State and Local Tax Deduction Cap on Pass-Through Business Taxpayers," *Florida Tax Review*: Vol. 25, Article 7.
Available at: https://scholarship.law.ufl.edu/ftr/vol25/iss1/7

This Article is brought to you for free and open access by UF Law Scholarship Repository. It has been accepted for inclusion in Florida Tax Review by an authorized editor of UF Law Scholarship Repository. For more information, please contact jessicaejoseph@law.ufl.edu.

FLORIDA TAX REVIEW

Volume 25 *2021* *Number 1*

Too Much SALT? The Nuanced Impact of the State and Local Tax Deduction Cap on Pass-Through Business Taxpayers

by

Jeffrey H. Kahn, Miles A. Romney** and John S. Treu****

Abstract

Perhaps the most controversial provision of the Tax Cuts and Jobs Act of 2017 is the state and local tax deduction limitation (or SALT cap), particularly with respect to how the cap impacts pass-through entities in high-tax states. This particular provision of the tax law has been criticized by opponents as deliberately punitive to small businesses in blue states, while proponents maintain that eliminating the SALT cap would primarily benefit high income taxpayers. Politicians from blue states have called for the repeal of the SALT cap, and some states have enacted various workarounds with questionable prospects of success. Still, many taxpayers will not benefit from a SALT deduction irrespective of the SALT cap, particularly taxpayers that either take the standard deduction or are

---

* Harry M. Walborsky Professor of Law and Associate Dean for Business Law Programs, Florida State University College of Law.

** Assistant Professor, Florida State University College of Business.

*** Assistant Professor, West Virginia University Chambers College of Business and Economics.

We gratefully acknowledge financial support from the College of Business at Florida State University and the John Chambers College of Business and Economics at West Virginia University. We thank Jeff Hoopes, Bridget Stomberg, Brady Williams and participants at the 2020 BYU Accounting Research Symposium for their feedback. We especially thank associates and partners in practice for reviewing our simulated tax returns and Brian George, Emily Mathess and Jordan Harcombe for their research assistance.

subject to the alternative minimum tax (AMT). We examine the developing law around the SALT cap and provide descriptive empirical evidence of its disparate impact on closely held business taxpayers. Consistent with prior economics literature, we find that the impact is indeed most pronounced among high-income taxpayers in blue states. However, we note that the impact is substantially less than the furor over the limitation would suggest because many high-income taxpayers are subject to the AMT and so are not significantly affected by the limitation. These findings suggest two underemphasized points. First, the imposition of the SALT cap was not the drastic financial hit to blue state taxpayers that policy makers and commentators have suggested. Second, with a new administration that favors eliminating the SALT cap, Congress could consider whether the repeal of the cap alone is enough because further changes would be needed to return the SALT deduction to its earlier prominence.

I. Introduction 341
II. The Law of the State and Local Tax Deduction 345
A. The Diminishing Importance of the State and Local Tax Deduction 345
B. Reaction to the TCJA Cap 349
1. New York v. Mnuchin 350
2. Charitable Tax Credits 354
a. Operation of the Work Around 354
b. The Future of the State Tax Charitable Credit 360
3. New York's Payroll Tax 362
4. Entity Level Taxation 363
III. Empirical Evidence of the Effects of the Salt Deduction Cap From Aggregated Return Filings 364
A. Prior Empirical Research on SALT Deduction 364
B. Aggregated Returns Data 365
C. SOI Changes Analyses 366
D. Results of SOI Changes Analyses 367
IV. Evidence of the Impact of the SALT Deduction Cap on Business Owners from Simulated Tax Return Data 369
A. Research Design for Simulations 369
B. Simulation Results Comparing Multiple Income Levels and Different Entity Types Across High- and Low-Tax States Indicate that Adverse Impacts of SALT Cap are Primarily Among High-Income Taxpayers 373

C. *Simulation Results with Additional Income and Variations in Long-Term Capital Gain Amounts Suggest Impact of SALT Cap is Nuanced Even Among High-Income Taxpayers* 378
V. CONCLUSION 385

I. INTRODUCTION

The Tax Cuts and Jobs Act of 2017 (TCJA) implemented wide-ranging structural changes to the taxation of U.S. businesses and individuals.[1] The overall stated purpose of the TCJA was to simplify the Tax Code, broaden the tax base and reduce tax rates. However, a controversial change, particularly for small business owners in high-tax states, involved the imposition of a hard cap of $10,000 on the deduction for all state and local taxes (hereinafter the "SALT cap").[2] At least some form of the state and local tax deduction has existed since the inception of the income tax, but the proliferation of flowthrough entities over time impacted the nature and extent of the underlying taxes being deducted. The SALT cap limits the deduction for all state and local taxes paid by individual taxpayers, which for most taxpayers will primarily include state income taxes and property taxes on personal residences. However, while the limit applies to individuals, business owners structured as S corporations, LLCs and sole proprietorships take the deduction for state and local taxes paid on business income at the individual level. Therefore, the SALT deduction for many small and closely-held business owners can arise primarily from taxes paid on business income rather than from taxes on wages or personal property ownership. Additionally, because the deduction is based on actual taxes paid, business owners in low-tax states would tend to benefit less from the deduction than

---

1. William Gale, Hilary Gelfond, et al., *A Preliminary Assessment of the Tax Cuts and Jobs Act of 2017*, 71 NAT'L TAX J. 589 (2018).

2. While the SALT cap was adopted for the first time under the TCJA, debates over its soundness have been going on for several decades. For example, in 2005, President George W. Bush convened an advisory panel that declared that the elimination of the SALT deduction would help create a "cleaner and broader tax base" as well as a more equitable Tax Code. Gilbert E. Metcalf, *Assessing the Federal Deduction for State and Local Tax Payments*, 64 NAT'L TAX J. 565; Jared Walczak, *The State and Local Tax Deduction: A Primer*, FISCAL FACT, (MARCH 14, 2017), https://taxfoundation.org/state-and-local-tax-deduction-primer/ [https://perma.cc/8LSQ-Q7Aq].

business owners in high-tax states. Hence, at least in theory, the limitation would have a greater negative impact on business owners in high-tax states than similarly situated businesses in low-tax states.

A repeal of the Federal SALT cap was a major talking point for many Democrats in the 2018 mid-term election, and the House passed the "Restoring Tax Fairness for States and Localities Act" (HR 5377) in late 2019, even though the proposed legislation was certain to die in the Republican-controlled Senate or face a presidential veto.[3] The White House's stated position was that the SALT deduction disproportionately benefits higher income households; thus, imposing the SALT cap funds tax relief to middle-income households.[4]

Elected state officials from blue states where state taxes tend to be higher are critical of the SALT cap and view it as an unfair disadvantage for taxpayers within their states. Simply limiting a personal deduction as opposed to a business deduction would likely be far less controversial as there is a long history of capping[5] or otherwise limiting[6] personal itemized deductions, particularly for taxpayers at higher income

---

3. *See* Jim Tankersley & Emily Cochrane, *SALT Tax Increase That Burned Blue States is Targeted by Democrats*, N.Y. Times, Dec. 19. 2019 https://www.nytimes.com/2019/12/19/business/salt-tax-repeal.html [https://perma.cc/ZQ6E-3DX8].

4. White House. THE TAX CUTS AND JOBS ACT, Feb. 2019, https://www.whitehouse.gov/wp-content/uploads/2018/02/WH_CuttingTaxesForAmericanWorkers_Feb2018.pdf. [https://web.archive.org/web/20180314022330/https://www.whitehouse.gov/wp-content/uploads/2018/02/WH_CuttingTaxesForAmericanWorkers_Feb2018.pdf].

5. For example, taxpayers may deduct qualified residence interest on "acquisition indebtedness," that is, debt that was incurred in acquiring or substantially improving a residence. § 163(h)(2)(D). However, the TCJA placed a cap of $750,000 on the amount of debt that a taxpayer may claim as acquisition indebtedness. § 163(h)(3)(F).Unless otherwise stated, all statutory section citations are the Internal Revenue Code of 1986, as amended, and all regulations section citations are to Treasury regulations promulgated thereunder.

6. Prior to the TCJA (which suspended miscellaneous itemized deductions through 2025), there was a 2% of adjusted gross income floor for miscellaneous itemized deductions. § 67(a). Without Congressional modification, this floor will return in 2026. § 67(g). Also, many itemized deductions are subject to a floor. For example, taxpayers may only deduct medical expenses to the extent such expenses exceed 7.5% of the taxpayer's adjusted gross income. § 213(a).

levels. The SALT deduction itself has evolved over time with respect to the deductibility of sales taxes on non-business purchases. Also, the significant majority of states that have income taxes do not permit a deduction for federal income taxes paid.[7] As such, the limitation might not be particularly controversial as applied only to personal deductions, but the impact on small businesses was viewed as particularly egregious.

State legislators in Connecticut were so concerned over the limitation's impact on local businesses that the state restructured its entire system of flowthrough entity taxation in an effort to permit businesses to continue to take the deduction.[8] Described in detail in Part II below, states considered several other possible workarounds such as a charitable tax credit program or shifting employee taxes to employers.[9]

Prior research modeling the impacts of the SALT cap identifies a differential effect on red- and blue-state (i.e. low- and high-tax state) taxpayers.[10] Specifically, Altig et al. estimate the differential in lifetime spending increases incident to the TCJA, finding the law benefitted red-state taxpayers more than blue-state taxpayers.[11] This differential was most pronounced among the richest ten percent of households where the differential was almost entirely driven by the SALT cap.[12] However, the true impact of the SALT cap on business owners must be determined in the context of other existing tax provisions that already limit or eliminate tax benefits from the SALT deduction. For example, the alternative minimum tax (AMT) and the general limits on itemized deductions can prevent or limit a business owner from benefitting from

---

7. *See* Inst. Tax'n & Econ. Pol'y, *Why States that Offer the Deduction for Federal Income Taxes Paid Get it Wrong, Institute on Taxation and Economic Policy,* (August, 2011) https://itep.sfo2.digitaloceanspaces.com/pb51fedinc.pdf [https://perma.cc/U8J5-EXSZ.

8. The state attempted two different workarounds to the SALT limitation, the first of which failed to receive the blessing of the IRS, but the second attempt may have succeeded. Kelly Zegers, *Connecticut Residents Warned State's SALT Workaround Won't Hold Up,* Daily Tax Rep't [BL], Aug. 6, 2019, https://news.bloombergtax.com/daily-tax-report/irs-pushback-on-salt-workarounds-worries-connecticut-tax-pros [https://perma.cc/6Q75-ZA8G]. *See infra* Part II(b)(4).

9. *See infra* Part II. The Law of the State and Local Tax Deduction.

10. David Altig et. al., *Did the 2017 Tax Reform Discriminate Against Blue-State Voters?,* 73 Nat'l Tax J. 1087 (2020).

11. *Id*. at 1096.

12. *Id.* at 1105.

an otherwise permissible SALT deduction.[13] Alternatively, a business owner that takes the standard deduction derives no benefit from itemized deductions, and the TCJA dramatically increased the standard deduction amount. Hence, the SALT cap may have little or no impact on business owners at low-income levels.

We conduct two analyses to better understand the impacts of the SALT cap. First, we analyze the impact of the SALT deduction more generally based on the Internal Revenue Service's (IRS) Statistics of Income (SOI) data, which provide actual taxpayer data aggregated by income level and location. We find that the highest-income taxpayers in blue states paid 0.4% higher taxes than their red- (or purple-) state counterparts. This effect remains in zip codes with business owners with tax attributes suggesting the sale of their business occurred.

Second, we conduct simulations of various business owner scenarios in two high income tax states (New York and California) and two low income tax states (Texas and Florida). We utilize tax preparation software to prepare various before-and-after scenarios for business owners in high-tax and low-tax states around the enactment of the TCJA. We then had these returns reviewed by tax professionals and revised the tax returns based on guidance received in the review process. We simulate the change in the effective tax rates (ETRs) of taxpayer owners before and after the TCJA under various alternative scenarios, including: (i) in two high-tax and two low-tax states, (ii) at several different income levels, and (iii) among different entity types. Simulated middle- to low-income business owners from high-tax states typically were not impacted at all by the SALT cap because these taxpayers tended to take the higher standard deduction under the TCJA. We then simulate high income taxpayer owners under the alternative scenarios of exclusively ordinary income versus half ordinary income and half long-term capital gains.[14]

Our analyses indicate that business owners with the highest income levels in the highest-tax states with primarily ordinary income are the most severely impacted by the SALT cap. The effect is greatly

---

13. § 56(b)(1)(A). In 2018, the AMT helped to raise about $5.2 billion (or 0.4% of all Federal income tax revenue). URBAN INST. & BROOKINGS INST., *The Tax Policy Center's Briefing Book: How much revenue does the AMT raise?*, https://www.taxpolicycenter.org/briefing-book/how-much-revenue-does-amt-raise [https://perma.cc/R9DL-5VJG].

14. We choose these two scenarios as their tax attributes most closely mirror those of business owners depending on the structure of their business as C corporations or flowthrough entities.

reduced among high income business owners with significant capital gains that are subject to AMT, and the limitation has no differential effect for business owners at lower levels of income. Taken together, our findings suggest that high income taxpayers in blue states with high levels of ordinary income are the most significantly impacted by the SALT cap introduced under the TCJA. Using this data, we illustrate that repealing the SALT cap alone is not enough if the goal of policymakers is to allow all taxpayers in the high-tax blue states to benefit from the state and local tax deduction.

II. The Law of the State and Local Tax Deduction

Section 164 simply states that a taxpayer is allowed a deduction for "State and local, and foreign, income, war profits, and excess profits taxes."[15] Section 164 is required to allow taxpayers to deduct their state and local taxes as otherwise such expenses would be deemed personal and therefore not deductible under the federal income tax system.[16] Section 164 is not applicable to state and local taxes imposed on income that is connected to a trade or business or a profit-seeking venture. Those expenses are deductible under sections 162 (trade or business) or 212 (profit-seeking) and so neither section 164 nor the limitations that apply to that provision have any bearing on those deductions. Any reference in this article to state and local taxes refers to such taxes that are not connected to a trade or business or a section 212 activity.

A. The Diminishing Importance of the State and Local Tax Deduction

A deduction for state and local income taxes has been a part of the federal income tax system since the very beginning,[17] although its importance has waxed and waned over the century-plus that we have had a federal income tax. Lately (the past 20-30 years), the importance of the deduction has mostly waned for reasons discussed below. Based on reporting at the time, one could be forgiven for thinking that the TCJA

15. § 164(a)(3). With one minor exception related to generation-skipping taxes, payments of federal taxes are not deductible. I.R.C. 164(a).

16. § 262.

17. The deduction was allowed in the first modern federal income tax act in 1913. Act of Oct. 3, Ch. 16, § II(B), 38 Stat. 114, 167-168 (1913).

was the near fatal blow for the deduction.[18] As we discuss below, this was a misconception, but the recent election results likely mean an even quicker resuscitation of the deduction.

Still, throughout the history of the federal income tax, the importance and usefulness of the state and local tax deduction has mostly eroded. Fewer and fewer taxpayers have directly benefited from the allowance of the deduction. One of the first major blows was the introduction of the standard deduction in 1944.[19] The adoption of the standard deduction meant that taxpayers had to elect to use either the standard deduction or their itemized deductions; they could not deduct both.[20] Taxpayers obviously elect to utilize the deduction that will provide the greatest tax benefit—that is, the one that will reduce their overall income tax liability the most.

The introduction of the standard deduction also required the introduction of different types of classifications for deductions. If a deduction was listed as a nonitemized deduction then any taxpayer, whether they were using the standard deduction or itemized deductions, could use that deduction to reduce their taxes.[21] If a deduction was classified as an itemized deduction, then only the taxpayers whose total itemized deductions exceeded the standard deduction amount would benefit from that deduction.

With the introduction of deduction classifications, the deduction for state and local taxes was (and still is) classified as an itemized deduction.[22] Thus, any taxpayer who used the standard deduction to reduce their income did not directly benefit from the state and local tax

---

18. *See* Joe Albanese, *The Political Economy of State and Local Tax Deductions After the New Tax Law*, Geo. Pub. Pol'y Rev., (June 20. 2018), http://gppreview.com/2018/06/20/political-economy-state-local-tax-deductions-new-tax-law/ [https://perma.cc/93XN-PAWA]; Ken Berry, *How to Mine 2017 Returns for SALT Deductions*, Accounting WEB, (Jan 17. 2018) https://www.accountingweb.com/tax/sales-tax/how-to-mine-2017-returns-for-salt-deductions/ [https://perma.cc/B4QH-YRS5].

19. Individual Income Tax Act of 1944, Pub. L. No. 315, §9, 58 Stat. 231, 236 (1944).

20. § 63(e).

21. Section 62 lists almost all of the deductions that are classified as nonitemized. § 62(a)(1)-(22).

22. § 67(b)(2).

deduction.[23] This change significantly reduced the number of taxpayers who used the state and local deduction in determining their federal income tax liability.

Another blow to the importance of the state and local tax deduction, and one that plays a major role in our contention that the 2017 limit and likely 2021 resurrection are not as momentous as some commentators (and some politicians) have suggested, is the adoption of the alternative minimum tax (AMT) in 1969.[24] When first enacted, the AMT was designed to ensure that a relatively small number of wealthy taxpayers were not taking excessive advantage of tax deductions and exemptions to reduce their final tax liability.[25] On account of the adoption of this system, all taxpayers are required to determine their tax liability under both the "regular" tax system and the AMT. Taxpayers will pay the liability imposed under whichever system creates the greater amount due.[26]

While the rates for the AMT are generally lower than the rates used in the "regular" system, the means by which taxpayers get ensnared by the AMT is that the AMT either reduces or eliminates several deductions or exemptions that are allowed under the regular system. One of the deductions subject to this rule is the state and local tax deduction—section 56(b)(1)(A) states that "no deduction shall be allowed . . . for any taxes described in paragraph (1), (2), or (3) of section 164(a)." Thus, any taxpayer subject to taxation under the AMT system does not derive any benefit from the state and local tax deduction.

Another provision that reduced the benefit of the state and local tax deduction was section 68. Under section 68, if a taxpayer's adjusted gross income exceeded a threshold amount then a percentage of that taxpayer's itemized deductions were disallowed (the "Pease limitation").[27]

---

23. We use the term "direct" because it is likely that some part of the standard deduction represents an estimate of what many taxpayers would otherwise pay in deductible state and local taxes.

24. Tax Reform Act of 1969, Pub. L. No. 91-172 § 56–58, 301, 83 Stat. 487, 580–86. (1969).

25. Douglas A. Kahn & Jeffrey H. Kahn, Federal Income Tax—A Guide to the Internal Revenue Code 739 (8th Ed. 2019).

26. § 55.

27. § 68(a). Donald Pease was a congressman who authored the limitation.

The maximum amount of disallowance possible under the provision was 20 percent of the taxpayer's itemized deductions.[28] Certain itemized deductions were exempted from this disallowance provision, but the state and local tax deduction was not one of them.[29] Therefore, this limitation affected the amount of benefit that certain high-income taxpayers would obtain from the state and local tax deduction. This limitation was suspended by the TCJA for tax years beginning in 2018 although it is scheduled to come back in force for tax years beginning in 2026.[30]

The most recent major blow to the state and local tax deduction was enacted by the TCJA. Under the TCJA, beginning in 2018, the total amount of taxes that could be deducted under section 164 was capped at $10,000.[31] Many commentators described this change as one of the most controversial for the TCJA.[32] As noted above, one could be forgiven for thinking this was close to the final straw that would break the camel's back by eliminating the deduction altogether. That view, however, was misguided as the $10,000 cap applies only to tax years between 2018 and 2025.[33]. Thus, even without any change, beginning in 2026, the

---

28. § 68(a)(2).

29. I.R.C. § 68(c). The limitation did not apply to deductions for medical expenses, investment interest, personal casualty and theft losses, and wagering losses.

30. § 68(f).

31. § 164(b)(6).

32. Stephen Fishman, *How does the Tax Cuts and Jobs Act Affect Homeowners?* Nolo, https://www.nolo.com/legal-encyclopedia/how-does-the-tax-cuts-and-jobs-act-affect-homeowners.html/ [https://perma.cc/K6UJ-PTYH] (last visited Feb. 14, 2021), ("Among the most controversial provisions in the Tax Cuts and Jobs Act are those reducing the tax benefits of homeownership."); Nick Spoltore, *SALT-y High Tax States File Appeal* (Dec. 4, 2019), https://www.surgentcpe.com/blog/high-tax-states-file-salt-appeal/ [https://perma.cc/8KR8-W9J6] ("[O]ne of the most controversial changes was the limitation of the State and Local Tax . . . deduction."); Marc Finer & Murtha Cullina, *IRS Provides Certainty Regarding Deductibility of Connecticut Pass-Through Entity Tax Payments*, JDSupra (Nov. 20, 2020), https://www.jdsupra.com/legalnews/irs-provides-certainty-regarding-30967/ [https://perma.cc/F3RX-UNY5], ("[O]ne of the most controversial individual income tax changes enacted under the Tax Cuts and Jobs Act is the $10,000 cap on the deduction for state and local income and property taxes.").

33. § 164(b)(6); Tax Cuts and Jobs Act, Pub. L. No. 115-97, §1104, 131 Stat. 2054 (2017).

deduction reverts back to its capless application. Still, it is possible that we will not need to wait even that long. With the recent election results, some expansion of the deduction is likely. The House version of President Biden's Build Back Better legislation raises the cap to $80,000 for all taxpayers.[34] While it is unlikely this proposal will pass through the Senate without amendment, it is likely that the compromise will be at least some expansion of the cap during Biden's presidency.[35]

B. Reaction to the TCJA Cap

Negative reaction to the cap was swift from high-tax states. Many officials and commentators viewed the cap as an attack on the "blue states" and decried the increased cost of state and local funding.[36] These states immediately considered ways to avoid the application of the cap. This part of the article reviews the four main avenues that states took in attempting to work around the cap: (1) several states simply sued the federal government arguing that the cap was unconstitutional; (2) several states attempted to disguise state and local tax payments as charitable contributions; (3) New York shifted the application of a payroll tax from the employee to the employer; and (4) several states imposed entity level taxation in lieu of imposing taxes on individual shareholders or partners.

---

34. H.R. 5376: Build Back Better Act, H.R. 5376, 117th Cong. § 137601(B) (2021) (as passed by House, Nov. 19, 2021).

35. Alyssa Fowers & Simon Ducroquet, *The Second Biggest Program in the Democrats' Spending Plan Gives Billions to the Rich*, Wash. Post (November 19, 2021), https://www.washingtonpost.com/business/2021/11/16/second-biggest-program-democrats-budget-gives-billions-rich/ [https://perma.cc/3X9C-Z7WX].

36. Kirk J. Stark, *The Power Not to Tax*, 69 Am. U. L. Rev. 565, 566 (2019) ("As a result of the new limitation, taxpayers now face a significant increase in the after-tax cost of funding education, health care, environmental protection—and a wide range of other essential services—particularly in 'blue states' where voters have typically demanded service levels requiring higher tax burdens."). Interestingly, this was not always a red state vs. blue state issue. For example, in 2010, President Obama created a National Commission on Fiscal Responsibility and Reform that proposed eliminating all itemized deductions, including the state and local tax deduction. *See* Nat'l Comm'n on Fiscal Responsibility and Reform, The Moment of Truth (Dec. 2010) https://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf [https://perma.cc/RQ5L-CDP8].

1. New York v. Mnuchin

As is the American way, one of the first actions that states took to counter the state and local tax deduction cap was to turn to litigation. Four states—Connecticut, Maryland, New Jersey and New York—sued the federal government challenging the constitutional validity of the new cap. The four states asked the court to declare that the new cap was unconstitutional and sought an injunction that barred the federal government from enforcing the limitation.[37]

At the district court level, the four states argued that the SALT cap would greatly increase the federal income tax owed by their residents. For example, the State of New York predicted "that its taxpayers will in many cases see their federal tax bills rise and will, in all, end up paying a total of $121 billion more into the federal coffers between 2018 and 2025 than they would have paid absent the cap."[38] The four states argued that the cap would disproportionately affect states with higher state and local tax systems.

While the easy response to this point is so what, the four states argued that this differential impact was intended by the Republican Party. That is, the "true purpose" of the cap was not to limit deductions or raise revenue, but instead was to force high-tax states, again mainly blue states, to change their state and local tax systems or their overall government spending. The four states argued that this animus toward the high-tax states violated the Constitution as it interfered with the "sovereign authority of the States to determine their own taxation and fiscal policies."[39] The federal government countered by moving for summary judgment on the basis of "lack of jurisdiction and for failure to state a valid legal claim."[40]

The federal government used three arguments to support its contention that the court lacked subject-matter jurisdiction on the SALT cap issue. First, the federal government argued that the four states lacked standing to bring the proposed claim. The court rejected that argument.

---

37. New York v. Mnuchin, 408 F.Supp.3d 399 (S.D.N.Y. 2019). The decision was affirmed by the Second Circuit. New York v. Yellen, 15 F.4th 569 (2nd Cir. 2021). The appellate court decision is briefly discussed at the end of this section.

38. *Id*. at 405 (citing Dkt. No. 46 ¶ 50).

39. *Id*. at 406 (citing Compl. ¶ 117).

40. *Id.* at 42 (citing Dkt. No. 42).

The court noted that in order to find standing, the states must adequately demonstrate an injury that provides them the standing to sue.[41] The court agreed that the diminished revenues that states would suffer on account of the cap was enough of a direct and imminent injury to support the standing requirement. The cap, of course, does not directly affect the amount that the states will collect in state and local taxes (the direct effect of the cap will be to increase the federal tax bill of individuals whose SALT deduction was capped). However, the states persuasively argued that the SALT cap will negatively affect the value of real estate which in turn could cause residents to spend less (thereby diminishing sales tax collections) and also delaying property sales (thereby diminish state and local property tax collections).[42] This was enough to convince the court that the states had a direct interest in the SALT cap and therefore the standing requirement was met under this challenge.

Second, the federal government argued that suit should be dismissed under the Anti-Injunction Act (AIA). The AIA generally disallows lawsuits which seek to bar the collection of federal taxes.[43] The federal government argued that since the case involved the SALT cap and thus the enforcement and collection of federal taxes, the states lacked standing under the AIA. Relying on Supreme Court precedent, the district court once again disagreed. The district court felt that the SALT cap case was similar to *South Carolina v. Regan*,[44] a 1984 Supreme Court case.

In *South Carolina v. Regan*, the State of South Carolina challenged the "elimination of a federal tax exemption that formerly excluded interest earned on state-issued bearer bonds from federally taxable income."[45] The federal government argued that since the provision was related to the collection of tax, South Carolina lacked standing under the AIA to challenge the elimination of the provision. The Supreme Court disagreed. The Supreme Court held that since South Carolina had no other legal avenue to challenge the validity of the new tax, the AIA did not bar the case.[46] The court in the SALT cap case

41. *See id.* at 406–410.

42. *See id.* §1.

43. § 7421(a).

44. 465 U.S. 367 (1984).

45. *Mnuchin*, 408 F. Supp. 3d at 411 (citing *Regan*, 465 U.S. at 370–71).

46. *Regan*, 465 U.S. at 373. ("Congress intended the Act to bar a suit *only* in situations which Congress had provided the aggrieved party with

dismissed the federal government's attempt to distinguish *Regan* on the ground that individual taxpayers could sue the federal government in a refund action to attempt to invalidate the SALT cap, and so there was another avenue to litigate the issue. Since the states had a direct financial interest in the provision and since there was no other legal avenue for the states to pursue a challenge to the cap, the district court held that the AIA did not bar the states from litigating the issue.[47] The availability to individual taxpayers to litigate the issue did not provide the state with a means to litigate if those individuals chose not to do so.

The final argument that the federal government used to claim that the states lacked standing was the political question doctrine. As noted by the district court, the political question doctrine applies when the controversary either involves a matter that should solely be in the hands of the executive or legislative branches or where there is a lack of "judiciable" standards for resolving the dispute.[48] The district court noted that the federal government was not contending that the question as to whether there are limits to federal tax policy is a matter for resolution for the government branches other than the judicial system.[49] Instead, the issue was whether the doctrine applied because there was a lack of standards that the court could use to determine the case. The district court held that this is not the situation for the cap case and so the court found that the political question doctrine did not bar the states standing to challenge the SALT cap.[50]

Since the district court found that the states had standing, it next turned to the actual merits of the challenge. The district court succinctly noted that essentially the issue was whether the SALT cap exceeded "the federal tax power by verging into territory that is constitutionally reserved to the states."[51] The states tried two arguments to support this: (1) the SALT deduction has "special historic status" and thus any attempt to limit or eliminate it violates the balance of state-federal power, and (2) the SALT cap was passed in order to "coerce" blue states, which violates their sovereign power.

---

an alternative legal avenue by which to contest the legality of a particular tax." (emphasis added).

47. *Mnuchin*, 408 F. Supp. 3d at 413.

48. *Id*. (quoting Nixon v. U.S., 506 U.S. 224 (1993)).

49. *Id*. at 414.

50. *Id*. at 414–15.

51. *Id*. at 415.

The district court dismissed both of these arguments. While noting that the SALT deduction has been an element of the federal income tax system from the beginning of the modern federal income tax system, the court refused to hold that longevity equals permanence. The district court correctly noted that the real question is whether there is any constitutional barrier to the federal government in limiting or eliminating the SALT deduction. The district court noted that the SALT cap in no way limits how states exercise their own taxing power and so in the end the SALT cap does not interfere with the states' sovereign taxing authority. The district court concluded that although the cap may be a "novelty" (although, as noted above, the SALT deduction has been gradually eroded away from full deductibility for many years), that does not mean that Congress did not have the constitutional authority to limit it.

For the second argument, the states contended that the federal government specifically passed the law in order in order to coerce them to adopt specific policies. For example, the states argued that the cap is an attempt to coerce the states to adopt lower state income tax rates.[52] The district court disagreed. The district court noted that federal law is not unconstitutional merely because it attempts to affect state policies. Citing *South Dakota v. Dole*[53] (the Supreme Court case involving highway funds and state drinking age), the district court held that federal government's taxing power can be used to influence states even in situations where direct regulation is not possible. Again, the key was that the states were still free to adopt their own state tax policy and the SALT cap did not change that. The district court did not agree that the cap was so detrimental that it left the states without any real choice.[54]

In the end, the district court correctly held that the states failed to prove that Congress did not have the constitutional authority to cap the SALT deduction, and so the federal government's motion to dismiss was granted by the court. The states appealed to the Second Circuit, but that court upheld the decision.[55] The Second Circuit agreed with the lower

52. *Id*. at 418 (citing Dkt. No. 45 at 26-36).

53. South Dakota v. Dole, 483 U.S. 203 (1987).

54. *Mnuchin*, 408 F. Supp. 3d at 420 ("[E]ven if . . . Congress enacted the SALT cap in order to exert downward pressure on state and local tax rates, such motive poses no constitutional problem as long as the states remain free 'not merely in theory but in fact' to set their own tax policies." (quoting *Dole*, 483 U.S. at 211-12.)).

55. New York v. Yellen, 15 F.4th 569 (2nd Cir. 2021).

court on both issues: first, that the states had standing to challenge the limitation,[56] and second, that there was no constitutional problem with Congress's imposition of the SALT deduction cap.[57] While the states have submitted a petition for certiorari,[58] it is unlikely the result will change even if the Supreme Court hears the case. The states' best hope is still a political one and, although a full repeal of the cap appears unlikely, a partial repeal is possible with the support of the Democrats.[59]

2. Charitable Tax Credits

a. Operation of the Work Around

Another attempt by states to find a viable workaround for the SALT cap was the use of charitable tax credits. Several states passed laws that allowed taxpayers to donate to a fund that was controlled by state and local governments and thereby qualify for a credit against their state or local income tax liability. The aim was for the payment to qualify as a charitable contribution deduction under section 170.[60] The obvious purpose of these laws was to avoid the new SALT cap by labeling state income tax payments as deductible charitable contributions.

No state adopted a full dollar for dollar credit for qualified donations. New York, for example, limited the credit to 85% of the amount of the donation.[61] On account of the $10,000 SALT cap, even at only 85%, the credit provided a tax benefit to taxpayers if the Service accepted the legitimacy of it. Take a simple example to highlight the advantage.

> EXAMPLE: Assume A, a resident of New York, is in the 35% marginal federal income tax bracket. A has $50,000 in state income tax liability. The first option is for A to just pay the state tax bill directly. A will pay a total of $50,000. Under the SALT cap, A will be able to

---

56. The Second Circuit held that the states had alleged an injury in fact and that the Anti-Injunction Act did not bar the claim. *Id*. at 575–79.

57. *Id*. at 579–84.

58. Petition for certiorari filed at (Jan. 03, 2022)(No.21-066).

59. See text accompanying notes 34–35.

60. § 170(a) states in pertinent part: "[t]here shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year."

61. N.Y. Tax Law §606 (hhh)(2)(iii) (McKinney 2020).

> deduct only $10,000 for federal income tax purposes, which provides $3,500 in tax savings. The second option is to pay approximately $58,823.53 to a qualified charitable organization. This payment will cover the $50,000 state tax bill under the 85% credit program. However, the SALT cap is avoided; and instead the taxpayer will deduct the payment under section 170 as a charitable contribution deduction. If allowed, this deduction generates $20,588 in tax savings. Therefore, under option 1, the state tax liability costs the taxpayer $46,500 ($50,000 minus the tax savings of $3,500) whereas option 2 costs the taxpayer $38,235 ($58,823 minus the tax savings of $20,588). Option 2 is the better choice even without a full dollar-for-dollar credit.[62]

The Service responded quickly to these proposals. In Notice 2018-54, the Service notified the public that the government intended to propose regulations addressing the issue.[63] Although the notice did not explicitly dismiss the validity of such programs, it was not hard to see the suggestion that the Service would not accept the validity of these attempted workarounds. The Service 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 tax purposes. . . . The proposed regulations will make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal tax treatment of such transfers."[64]

Even before the regulations were proposed and finalized, commentators noted several red flags concerning states' use of the charitable deduction to avoid the SALT cap. For example, Professor

---

62. There is the potential for even more tax savings under option 2. Taxpayers who pay their entire state income tax bill using the charitable credit method can elect to deduct their state sales taxes (up to the $10,000 SALT cap) under section 164(b)(5). Amandeep S. Grewal, *The Charitable Contribution Strategy: An Ineffective SALT Substitute*, 38 Va. Tax Rev. 203, 209 (2018). Professor Grewal notes that under the partial credit model the real loser is the federal government since the state government also ends up with more money under option 2. *Id*. at 210.

63. I.R.S. Notice 2018-54, 2018-24 I.R.B. 750.

64. *Id*.

Grewal raised three possible objections: (1) Quid Pro Quo; (2) Income Inclusion; and (3) Substance Over Form. Under the first objection, Professor Grewal noted that the Service could argue that receiving a state or local income tax credit could disqualify the donation from qualifying for a charitable contribution deduction under section 170. The regulations under section 170 state that a taxpayer does not receive a charitable contribution deduction to the extent that the payment is "in consideration for . . . goods or services . . ."[65] Courts as well have consistently held that donations do not qualify if the taxpayer receives tangible value in return.[66]

Under objection two (Income Inclusion), Professor Grewal noted that if the Service takes the position that receiving a tax credit on account of the donation is income to the donor then any benefit of the attempted work around falls apart. While the taxpayer would get a full charitable deduction, the corresponding income from the state or local tax credit would wipe out any tax benefit. Professor Grewal rightly notes that this is the riskiest argument in opposition to the SALT cap work around as the Tax Court has generally taken the position that such credits are excluded from income.[67]

The final objection noted by Professor Grewal is a substance over form argument. Under this approach, the Service would argue that the donation is in substance a state or local tax payment and thus should not qualify for a section 170 deduction. Instead, it should be treated as section 164 state or local tax payment and thus would once again be subject to the SALT cap. Although, as discussed below, the Service and Treasury did not go this route when finalizing new regulations to address this issue, this treatment would avoid potential issues for the Service that might still exist even with the regulation change.

As noted above, the Service and the courts have held that a taxpayer can only take a charitable deduction for the amount that the

---

65. § 1.170A-1(h)(1).

66. *See* United States v. Am. Bar Endowment, 477 U.S. 105 (1986). Under these rules, a taxpayer may only take a charitable contribution deduction to the extent that the donation exceeds the value of what the taxpayer received in consideration of the gift.

67. *See, e.g.*, Maines v. Commissioner, 144 T.C. 123, 134 (2015). Professor Grewal does note some exceptions where the courts instead applied an income inclusion approach. Consol. *See, e.g.*, Edison Co. v. United States, 10 F.3d 68 (2d Cir. 1993).

donation exceeds the value of consideration of "goods or services" that the donor receives in exchange for the donation. The million-dollar question then is whether a state or local tax credit qualifies as a good or service under the regulation. Even prior to the regulations finalized after Notice 2018-54 (which answers the question clearly as discussed below), a good or service was defined broadly as including "cash, property, services, benefits, and privileges."[68] Certainly a strong argument suggests that a state or local income tax credit qualifies as a "benefit" under that regulation.

Another approach for the government is to treat the credit as a reimbursement to the taxpayer of that amount of the contribution so that only the amount donated in excess of credit would be deductible as a charitable contribution.

It is worthwhile to note that these charitable credit programs were not unprecedented before the SALT cap. Several states had programs in place prior to the 2017 TCJA and it does not appear that the Service challenged these programs. For example, in Michigan, taxpayers who donated to qualified charitable programs that performed public functions were entitled to a tax credit against their Michigan state income tax liability equal to 50 percent of their donation.[69] So, for example, if an individual donated $100 to the University of Michigan, they would receive both a $100 charitable contribution for the federal income tax and a $50 state tax credit for the Michigan income tax.

If this program did not cause issues with the Service, why did the new ones? The answer is likely both the amounts involved and the purpose of the program. The Michigan credit was capped at $100 per taxpayer[70] so the dollars involved were not significant. Perhaps more importantly, the purpose of these programs, unlike the recent charitable credits, was not to intentionally evade a federal tax limit like the SALT cap.

Commentators in favor of allowing the charitable credit scheme to work cited a 2011 Chief Counsel Advisory[71] memorandum to support their

---

68. § 1.170A-1(h)(4)(ii).

69. Mich. Comp. Laws. Ann. §206.261 (*repealed by* 2011 Mich. Pub. Acts 16).

70. *Id*.

71. I.R.S. CCA 201105010 (Feb. 4, 2011). A Chief Counsel Advisory is an internal memorandum written by the Service, and, while it provides some information about the Service's thinking on an issue, it may not be cited as precedent. § 6110(k)(3).

conclusion.[72] That memorandum dealt with the specific issue of whether a "payment of cash to either a state agency or a charitable organization" that entitled the taxpayer to a state tax credit should be considered a charitable contribution under section 170 or a payment of state tax deductible under section 164. In the memorandum, the Service concluded that the payment should qualify as a charitable contribution deduction under section 170 and not as a payment of tax under section 164.

The Chief Counsel Advisory appears to rely on the reasoning in the cases of *McLennan v. United States*[73] and *Browning v. Commissioner*[74] to arrive at that conclusion.[75] This is somewhat surprising as neither of these cases truly supports the conclusion that the Service takes in the memorandum. In both cases, the Service argued that the economic value of the charitable deduction that a taxpayer was to receive on account of a donation should reduce the amount that the taxpayer is deemed to have donated. Both courts rightfully reject this position as the benefit of a charitable deduction has never been considered consideration in exchange for a charitable donation. If it did, it would actually lead to strange results—for example, assume taxpayer donates $100 to a charity. Since she is in the 30% percent marginal tax bracket, this donation provides a $30 tax benefit from the charitable contribution deduction of section 170. Under the Service's argument, the amount of the deduction should therefore be reduced by the $30 tax benefit since she is receiving on account of the donation. However, if you reduce the charitable contribution deduction to $70, the taxpayer no longer has a $30 tax benefit, she only has a $21 tax benefit. So, do we increase the deduction to $79 which of course increases the tax benefit which may lead to another round of reductions and so on.[76] There is a vast difference between not taking into account the benefit from a federal income tax deduction and doing so for a state tax credit. A reduction of a gift for

72. *See* David Gamage et. al., *State Responses to Federal Tax Reform: Charitable Tax Credits,* 88 Tax Notes 433, 644 (2018).

73. McLennan v. United States, 994 F.2d 839 (Fed Cir. 1993), *aff'g* 24 Cl. Ct. 102 (1991) and 23 Cl. Ct. 99.

74. Browning v. Comm'r, 109 T.C. 303 (1997).

75. I.R.S. CCA 201105010 (Feb. 4, 2011) ("Based on our analysis of existing authorities, we conclude that the position reflected in *McLennan*, *Browning*, and similar case law generally applies.").

76. This is similar to the pyramiding argument in Old Colony Tr. Co. v. Comm'r, 279 U.S. 716 (1929).

the tax benefit from deducting it from federal income would conflict with the legislative purpose for granting the deduction—giving with one hand and taking back with the other. That conflict does not occur when the benefit from the contribution is derived from an agency other than the federal government.

The Service seemed to take the position that since the tax liability reduction from the receipt from a charitable deduction does not affect the amount of the section 170 deduction, the receipt of a state tax credit also does not affect the amount of the section 170 deduction. As noted above, those two situations are not comparable. In addition to questioning whether the CCA memorandum erred in treating them as comparable, the CCA memorandum itself noted that there were circumstances where the substance over form doctrine should apply to treat the charitable contribution as a state tax payment. The Service itself noted in the CCA memorandum that "[t]here may be unusual circumstances in which it would be appropriate to recharacterize a payment of cash or property that was, in form, a charitable contribution as, in substance, a satisfaction of tax liability."[77]

In the end, the Service and Treasury rejected the reasoning of the memorandum when it issued new regulations concerning this issue. The regulations added Treasury Regulation section 1.170A-1(h)(3)(i), which states in relevant part: "if a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c), the amount of the taxpayer's charitable contribution deduction under section 170(a) is reduced by the amount of any state or local tax credit that the taxpayer receives or expects to receive in consideration for the taxpayer's payment or transfer." In essence, the Service treats the credit as a reimbursement of the contribution. The operation of this regulation can be illustrated by returning to the example above.

> EXAMPLE: Remember that A, a resident of New York, is in the 35% marginal tax bracket. A has $50,000 in state income tax liability. Under the second option, A pays approximately $58,823.53 to a qualified charitable organization. This payment will cover the $50,000 state tax bill under the 85% credit program. However, under the regulation, A must reduce the amount of the charitable contribution deduction under section 170 by the amount of tax credit that A will receive for making the donation.

77. I.R.S. CCA 201105010 (Feb. 4, 2011).

> So, in the end, A receives only an $8,823.53 charitable contribution deduction ($58,823.53 minus the state tax credit of $50,000). This charitable contribution deduction produces $3,088.23 in tax savings. Thus, the total cost to A is $55,735.30, an amount significantly higher than just paying the $50,000 state tax liability directly. However, as we discuss below, there may still be an advantage to this treatment even under the new regulation.

Thus, the Service and Treasury adopted the quid pro quo or reimbursement contention for the rejection of allowing a full charitable deduction for a payment that qualifies the taxpayer for a state or local tax credit.

b. The Future of the State Tax Charitable Credit

With the new Democratic control of both Congress and the Presidency and the likely repeal of the SALT cap, the question arises whether this charitable contribution issue is moot just as the states' constitutional challenge likely is. Surprisingly, the answer may be no. Even with the repeal of the SALT cap, some taxpayers may still benefit from the state charitable tax credit scheme should states decide to keep them in effect. Once again, an example may be useful to illustrate the point.

> EXAMPLE: A taxpayer lives in the state of New York and earns enough income to be in the 35% marginal income tax bracket. However, on account of the taxpayer's financial situation, the taxpayer will be subject to the alternative minimum tax when determining the taxpayer's actual federal income tax liability. Assume that the marginal income tax rate under the alternative minimum tax is 25%. The taxpayer has a $50,000 state income tax liability. Once again, the taxpayer has two options—(1) pay the $50,000 tax liability directly or (2) pay $58,823.53 to a qualified charitable organization qualifying the taxpayer for a $50,000 state income tax credit.
>
> Assume Congress has repealed the SALT cap but otherwise makes no changes to the federal income tax treatment of state and local tax payments. Under the "regular" tax system, the taxpayer is clearly better off by paying the state income tax liability directly. The taxpayer will pay $50,000 to the state and deduct $50,000 on her federal return under section 164. Therefore, the total cost under the regular system is $32,500

($50,000 minus the deduction tax benefit of $17,500). However, as noted, the taxpayer is subject to the alternative minimum tax. Under the AMT, the state and local tax deduction is completely wiped out and provides no benefit under that system. Therefore, the actual cost to the taxpayer is the full $50,000 payment since there is no tax benefit to the deduction.

What are the results under option 2? If the regular tax system applied to the taxpayer, the taxpayer would receive a $58,823.23 charitable contribution deduction. Thus, the total cost of the paying the $50,000 tax liability would be $38,235.10. If the regular system applied, this is higher than the cost of paying the tax liability directly and so without the cap there is no benefit to the taxpayer. However, under the AMT, the results change. As noted above, the section 164 state and local tax deduction is eliminated under the AMT, but the charitable contribution deduction of section 170 is not. Thus, under the AMT system, the total cost to the taxpayer is $44,117.42 (the $58,823.23 charitable donation minus the tax benefit of the charitable contribution deduction under the AMT system). This is almost $6,000 less than the cost to the taxpayer if the taxpayer pays the tax directly.

As noted, this example assumes two things: (1) Congress repeals the SALT cap (very likely) and (2) Congress overrides the Treasury Regulation that treats the receipt of a state tax credit as a reimbursement or consideration under section 170 (not as likely). If only the cap is repealed, but Congress leaves the regulation as it is (treating the state or local tax credit as a reimbursement or a consideration), then once again any benefit of the structure goes away. Without any deduction under either the regular system or the alternative minimum tax, it will always be better for the taxpayer to pay the tax directly.

Of course, Congress may actually reverse the regulations. After the regulations came out, a proposal surfaced in the Senate to reverse them but, with Republican control of the Senate, that proposal failed.[78] Another possibility is that Congress amends the Tax Code and fully allows the state and local tax deduction under both the regular system

---

78. Naomi Jargoda, *Senate Rejects Dem Measure to Overturn Rules on SALT Cap,* The Hill (Oct. 23, 2019) https://thehill.com/policy/finance/467158-senate-rejects-dem-measure-to-overturn-irs-rules-on-salt-deduction-cap [https://perma.cc/L23Y-8MSV].

and the AMT. One way to accomplish that is to transform the state and local tax deduction to a nonitemized one. This would allow all taxpayers to deduct their state and local income tax payments whether they itemize their deductions or use the standard deduction. It would also allow the deduction to be fully used under the AMT since nonitemized deductions are not limited under that system. If Congress did not want to go that far, it could just allow the deduction to be used under the AMT system (similar to what the AMT allows for the charitable contribution deduction, which is an itemized deduction[79]) by removing section 56(b)(1)(A)(ii). Although the only proposal getting attention currently is the repeal of the SALT cap, democratic governors, sensing the iron is hot, may go for broke and seek to return the SALT deduction to its former full prominence.

3. New York's Payroll Tax

Another attempt by states to avoid the SALT cap was to shift individual state and local tax payments to business state and local tax payment. If successful, these structures avoided the SALT cap because the section 164 $10,000 cap was not applicable to businesses. One way to accomplish this shift is to require that an employer pay a tax which provides a credit for an employee's state and local tax liability. New York was one of the few states that employed this tactic.

New York established the Employer's Compensation Expense Tax (ECET). Under this system, an employer could elect to pay a small tax on compensation paid to employees. This tax would be deductible by the employer since it was a business and not subject to the SALT section 164 cap. Certain employees subject to the tax would get a credit for the amount that the employer paid on the employee's compensation. Very few businesses made this election so it was not a successful workaround.[80] If it had been, there is the possibility that the Service would have made the substance-over-form argument discussed in the charitable contribution section. However, with the forthcoming cap repeal, it is likely that the ECET and any other programs like it will also be repealed, particularly since very few businesses elected to take advantage of it.

---

79. § 55(c).

80. N.Y.U. Inst. on State & Local Tax'n § 9.02[5][b] (2020).

4. Entity Level Taxation

The final option for states that were attempting to avoid the SALT cap was to enact an entity-level tax on pass-through business entities. This is similar to the New York law discussed above as the goal is to shift the state and local tax liability from an individual to a business that is not subject to the cap. Some commentators felt this was the most likely option to survive the scrutiny of the Service.[81] The state of Connecticut was the first to adopt this option and it became the model for several others.[82]

Normally with pass-through entities, there is no state or federal taxation at the entity level. Instead, the income earned by the business entity (be it a partnership, S corporation, limited liability partnership or limited liability company) is passed through to the partners, shareholders or members (to save time, we will refer to this group as the owners). The owners would pay state or federal income tax on the income that was allocated to them. With the SALT cap in place, these payments by the owners would be subject to the $10,000 SALT cap.

Under the Connecticut law, the pass-through entity would be subject to a 6.99% tax on their Connecticut sourced income. Any individual owner of the pass-through entity would get a state income tax credit equal to a percentage of what the pass-through entity paid on the owner's share of the income.[83] The application of the law is complex, and Connecticut's Department of Revenue Services has already had to issue guidance on how pass-through entities should calculate the appropriate state tax.[84]

The Service and Treasury appear to be more favorably disposed toward the structure of this workaround. In Notice 2020-75, the Treasury Department announced that it intended to publish proposed regulations that covered the treatment of state and local income taxes imposed on

---

81. Bruce P. Ely & Kelvin Lawrence, *Insight: A More Viable SALT Cap Workaround? Pass-Through Entity-Level Taxes*, Daily Tax Report: State (BL) (July 11, 2019) [https://perma.cc/9XW2-KA4C].

82. Four other states adopted a similar program—Wisconsin, Oklahoma, Louisiana and Rhode Island. *Id*.

83. In 2018, the credit was 93.01% of the amount of tax paid. In 2019, it was reduced to 87.5%.

84. Conn. Dep't of Revenue Servs., *Connecticut Pass-Through Entity Tax Instructions*, 2019 Form CT-1065/CT-1120S1, https://portal.ct.gov/-/media/DRS/Forms/2019/Pass-Through/CT-1065-CT-1120SI-Booklet_1219.pdf [https://perma.cc/4YUU-VZEK].

pass-through entities such as a partnership or S corporation.[85] In the notice, the Treasury Department stated that the regulations would take the position that state and local income taxes paid by the pass-through entity would be "deductible by partnerships and S corporations in computing their non-separately stated income or loss."[86] Determining that these payments do not have to be separately stated when reporting income and deductions to the partner or S corporation shareholder is key because it means that the payment will not be taken into account when applying the SALT cap to that individual partner or S corporation shareholder. Thus, it appears that the Treasury Department will permit the workaround that shifts state and local income tax from individuals to the business pass-throughs such as in the Connecticut example above.

Still, with the likely repeal of the SALT cap, many states may just repeal this option, especially on account of its complexity. However, should the restriction of the SALT deduction under the AMT continue to apply, this type of program may still provide a tax benefit to taxpayers who would be subject to tax under that system since the shifting of the deduction avoids the AMT's full exclusion.

III. Empirical Evidence of the Effects of the Salt Deduction Cap From Aggregated Return Filings

A. Prior Empirical Research on SALT Deduction

Noto and Zimmerman consider four theoretical proposals regarding the limitation of state and local taxes and test those proposals empirically.[87] The first proposal is to eliminate sales tax deductibility. The second and third proposals impose a floor or ceiling, respectively, on all SALT deductions as a percentage of AGI. The fourth proposal disallows a percentage of tax payments as deductions.[88] The authors conclude the percentage of AGI floor is the preferred alternative, highlighting that the SALT ceiling is difficult to be "fair" if it must be expressed uniformly nationwide.[89] The ceiling proposal yields the largest mean increase (0.18%) and coefficient

---

85. I.R.S. Notice 2020-75, 2020-49 I.R.B. 1453.

86. *Id*.

87. Nonna A. Noto & Dennis Zimmerman, *Limiting State-Local Tax Deductibility: Effects Among the States*, 37 Nat'l Tax J. 539 (1984).

88. *Id*. at 539.

89. *Id*. at 546.

of variation (1.37) in Federal effective tax rates (ETRs) because of the great variability of state income tax rates throughout the United States.[90]

In a more recent analysis of a SALT deduction-free tax equilibrium, Kolpin derives mathematical models supporting three propositions.[91] First, the abolition of SALT deductions induces suboptimal welfare. Second, equilibrium tax policy can maximize federal welfare when permitting SALT deductions. Third, abolition of SALT deductions can lead to strict increases of aggregate equilibrium tax burdens.

Altig et al. model the impacts of the SALT cap to identify a differential effect on red- and blue-state (i.e. low- and high-tax state) taxpayers.[92] They estimate an average increase in remaining lifetime spending of 1.6 percent in red states versus 1.3 percent in blue states resulting from passage of the TCJA.[93] Furthermore, among the highest income households, that differential impact in lifetime spending increases to 2 percent for red-state taxpayers compared to only 1.2 percent in blue states.[94]

B. Aggregated Returns Data

We access the IRS SOI website to obtain aggregated tax return data.[95] With these actual taxpayer data—summarized by zip code—we examine the effects of the TCJA on taxpayers' actual taxes paid. We use data available for the tax years 2016, 2017 and 2018 to construct change variables for 2017 (last pre-TCJA year) and 2018 (first post-TCJA year). Zip code data show selected income and tax items classified by State, zip code and size of adjusted gross income (AGI). Data are based on individual income tax returns filed with the IRS and include various items, such as the number of returns (approximates the number of households), AGI, wages and salaries, dividends, interest received, business income, deductions, credits and total tax.

---

90. *Id.* at 545.

91. Van Kolpin, *Apolitical SALT-free Tax Equilibria*, 101 MATHEMATICAL SOC. SCI. 99 (2019).

92. Altig et. al., *supra* note 10.

93. *Id.* at 1105.

94. *Id.* at 1105.

95. I.R.S., *SOI Tax Stats—Individual Income Tax Statistics—Zip Code Data (SOI)*, https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-statistics-zip-code-data-soi [https://perma.cc/V89G-GYEM].

C. SOI Changes Analyses

Our changes analyses (difference-in-differences regressions) help us to test whether high-income taxpayers in high-tax states pay higher taxes (i.e., experience a smaller tax decrease) relative to other taxpayers after the passage of the TCJA limits their SALT deduction.

Using a methodology similar to that of Altig et al. to designate states as red, blue or purple, we identify a "blue" state as one where the Democratic share of total votes was, on average, five percentage points higher than the Republican share of total votes over the past five presidential elections.[96] Conversely, a "red" state is one where the Republican share of total votes was, on average, five percentage points higher than the Democratic share of total votes over the past five presidential elections.[97] We classify the remaining nine states as "purple" states.[98] In our empirical analyses, the "treatment group" is the blue states, while our "control group" is all red and purple states.

To test whether high-income taxpayers in blue states face higher ETRs than their non-blue state counterparts after the passage of the TCJA, we estimate the following ordinary least squares (OLS) regression:

$$\begin{aligned} \Delta ETR = {} & \alpha + \beta_1\, \textit{Post-TCJA} * \textit{Blue} + \beta_2\, \textit{Post-TCJA} + \beta_3\, \textit{Blue} \\ & + \beta_4\, \Delta \textit{Capital Gains \%} + \beta_5\, \Delta \textit{Schedule C \%} \\ & + \beta_6\, \Delta \textit{Schedule E \%} + \beta_7\, \Delta \textit{Total Itemized Deductions \%} \\ & + \beta_8\, \Delta \textit{Total Credits \%} + \beta_9\, \Delta \textit{Interest Income \%} \\ & + \beta_{10}\, \Delta \textit{Ordinary Dividend \%} \\ & + \beta_{11}\, \Delta \textit{Qualified Dividend \%} + \varepsilon \end{aligned}$$

where *ΔETR* is the change in the aggregated taxpayers' ETR (total tax liability amount (A10300) / adjusted gross income (A00100)) from the

96. Seventeen states (plus the District of Columbia) qualify as "blue" states in our sample: California, Connecticut, Delaware, Hawaii, Illinois, Maine, Maryland, Massachusetts, Michigan, Minnesota, New Jersey, New Mexico, New York, Oregon, Rhode Island, Vermont and Washington.

97. Twenty-four states qualify as "red" states in our sample: Alabama, Alaska, Arizona, Arkansas, Georgia, Idaho, Indiana, Kansas, Kentucky, Louisiana, Mississippi, Missouri, Montana, Nebraska, North Carolina, North Dakota, Oklahoma, South Carolina, South Dakota, Tennessee, Texas, Utah, West Virginia and Wyoming.

98. The nine "purple" states are Colorado, Florida, Iowa, Nevada, New Hampshire, Ohio, Pennsylvania, Virginia and Wisconsin.

prior year to the current year. Our variable of interest, *Post-TCJA*, is an indicator variable equal to one if the tax year is 2018 or later, meaning the TCJA's SALT cap is in effect. *Blue* is an indicator variable equal to one if the taxpayers in a given zip code file their Federal taxes in a "blue" (high-tax) state, as described previously. The remaining eight control variables in the equation reflect changes in various income, deduction, and credit amounts from the prior year to the current year. Including these control variables helps us to ensure that changes in taxpayers' ETRs are not driven by some other change in taxpayers' return compositions (e.g., increased capital gains income as a percentage of total taxable income reducing the taxpayers' ETRs).

A positive coefficient on *Post-TCJA * Blue* (β_1) suggests taxpayers in high-tax states saw a smaller reduction in ETR after the TCJA went into effect relative to their counterparts in low-tax states. A negative coefficient on *Post-TCJA* (β_2) suggests ETRs decreased for all taxpayers after the TCJA went into effect. Given the breadth of the TCJA's tax cuts, this result is unsurprising. The coefficient on *Blue* (β_3) represents the change in ETRs for pre-TCJA taxpayers in high-tax states relative to the change in ETRs for low-tax state taxpayers. We have no *a priori* expectations for a statistically significant coefficient on *Blue*. The eight included controls (β_4–β_{11}) for changes in various income, deductions and credits control for other changes in the composition of taxpayers' aggregated data that could also explain changes in ETRs from one year to the next. Our only *a priori* expectations for those eight control variables is that increases in income items taxed at higher (lower) ordinary (capital gains) tax rates will increase (decrease) ETRs from one year to the next. Similarly, we expect increases in tax deductions and credits will decrease ETRs from one year to the next.

D. Results of SOI Changes Analyses

We estimate our regression equation using our SOI zip code data. Table 1 presents the results of that estimation on all available zip codes in the tax years 2017 and 2018. In our full sample of 298,866 zip codes, we find a positive coefficient of 0.001 (p-value < .001) on our interaction term, *Post-TCJA * Blue*. This result suggests that, on average, taxpayers in blue states saw a decrease in their ETRs of 0.1% less than their red or purple state counterparts. The next six columns of Table 1 partition the sample using the IRS's six AGI "stubs:" 1) greater than $200K, 2) $100K-$200K, 3) $75K-$100K, 4) $50K-$75K, 5) $25K-$50K, and 6) less than $25K. The first AGI-stub partition (N = 32,015) speaks to the highest-income

Table 1: SOI Changes Analysis
All Zip Codes Partitioned by Adjusted Gross Income (AGI)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Dependent Variable: *ΔETR*	**Coefficient** ***(p-value)***	**Coefficient** ***(p-value)***	**Coefficient** ***(p-value)***	**Coefficient** ***(p-value)***	**Coefficient** ***(p-value)***	**Coefficient** ***(p-value)***	**Coefficient** ***(p-value)***
AGI Partition	**ALL**	**> $200K**	**$100K–$200K**	**$75K–$100K**	**$50K–$75K**	**$25K–$50K**	**< $25K**
Variable of Interest: ***(High t-Tax State = Blue)***							
*Post-TCJA * Blue*	0.001***	0.004***	0.003***	0.002***	0.000***	−0.000***	−0.001***
	(0.000)	***(0.000)***	***(0.000)***	***(0.000)***	***(0.000)***	***(0.001)***	***(0.000)***
Post-TCJA	−0.014***	−0.029***	−0.019***	−0.017***	−0.015***	−0.011***	−0.007***
	(0.000)	***(0.000)***	***(0.000)***	***(0.000)***	***(0.000)***	***(0.000)***	***(0.000)***
Blue	0.000	−0.000	0.000	0.000***	0.000	−0.000	0.000
	(0.249)	***(0.913)***	***(0.109)***	***(0.001)***	***(0.284)***	***(0.621)***	***(0.138)***
Observations	298,866	32,015	50,493	52,079	54,146	55,017	55,116
R-squared	0.412	0.432	0.463	0.643	0.619	0.522	0.275

This table presents the results of estimating our regression equation using SOI zip code Data using *ΔETR* as the dependent variable and Democratic (*Blue*) states as our variable of interest across the 2017 and 2018 tax years. This table estimates our regression equation across all zip codes available. Column (1) estimates the regression equation on all tax return zip codes. Column (2) estimates it for AGIs above $200K, while Columns (3) through (7) decrease in AGI_STUB.
We exclude change controls for the tax return line items for parsimony.
***, **, * indicate significance at the one percent, five percent, and ten percent levels, respectively.Continuous variables are winsorized at 1%/99%. Variables are defined in the Appendix.

taxpayers of most interest in our study. The coefficient of *Post-TCJA * Blue* for these highest-income taxpayers is 0.004 (p-value < .001), suggesting, on average, the highest-income taxpayers in blue states saw a decrease in their ETRs of 0.4% less than their red or purple state counterparts. This larger (than the full sample) coefficient makes sense given the lack of an upper bound on taxpayers' incomes (greater than $200K). It also suggests the highest-income taxpayers in blue states face a larger tax burden than the highest-income taxpayers in red or purple states.

In an effort to identify business owners, Table 2 presents the results of estimating our regression equation within the zip codes where taxable asset deals could possibly have taken place. A *possible* business-owner zip code has a non-zero number of tax returns with business/professional income (N00900), partnership/S corporation net income (N26270), and capital gains/losses (N01000). The coefficient on the interaction term, *Post-TCJA * Blue*, is 0.001 (p-value < .001) among all 157,125 possible business-owner zip codes. Among the highest-income taxpayers, the coefficient on the interaction term, *Post-TCJA * Blue*, is also 0.001 (p-value < .001) among 21,082 possible business-owner zip codes.

Table 3 presents the results of estimating our regression equation within the zip codes where our taxable asset deals are most likely to have taken place. These zip codes in the aggregate have tax returns with above-median percentages of business/professional income (15.4%), partnership/S corporation net income (1.7%), and capital gains/losses (14.3%). The coefficient on the interaction term, *Post-TCJA * Blue*, is 0.002 (p-value < .001) among all 79,316 likely business-owner zip codes. Among the highest-income taxpayers, the coefficient on the interaction term, *Post-TCJA * Blue*, is 0.001 (p-value < .01) among 20,574 likely business-owner zip codes.

In sum, these results show the highest-income taxpayers in blue states saw a decrease in their taxes of 0.1%—0.4% less than their red or purple state counterparts. As such, the SALT deduction limitation does, in fact, appear to have penalized blue-state high-income taxpayers with higher ETRs, although the economic significance of these differences in ETRs appears to be relatively small.

IV. Evidence of the Impact of the SALT Deduction Cap on Business Owners from Simulated Tax Return Data

A. Research Design for Simulations

To better understand the impact of the SALT deduction cap on business owners, we next conduct multiple simulations of business owner tax

Table 2: SOI Changes Analysis
***Possible* Business-Owner Zip Codes Partitioned by Adjusted Gross Income (AGI)**

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Dependent Variable: ***ΔETR***	**Coefficient** ***(p-value)***	**Coefficient** ***(p-value)***	**Coefficient** ***(p-value)***	**Coefficient** ***(p-value)***	**Coefficient** ***(p-value)***	**Coefficient** ***(p-value)***	**Coefficient** ***(p-value)***
AGI Partition	**ALL**	**> $200K**	**$100K–$200K**	**$75K–$100K**	**$50K–$75K**	**$25K–$50K**	**< $25K**
*Post-TCJA * Blue*	0.001***	0.001***	0.002***	0.001***	0.000***	0.000	–0.001***
	(0.000)	***(0.000)***	***(0.000)***	***(0.000)***	***(0.000)***	***(0.981)***	***(0.000)***
Post-TCJA	–0.014***	–0.029***	–0.020***	–0.020***	–0.018***	–0.015***	–0.007***
	(0.000)	***(0.000)***	***(0.000)***	***(0.000)***	***(0.000)***	***(0.000)***	***(0.000)***
Blue	0.000***	0.001***	0.001***	0.000***	–0.000	–0.000*	0.000
	(0.000)	***(0.003)***	***(0.000)***	***(0.000)***	***(0.213)***	***(0.091)***	***(0.394)***
Δ Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	157,125	21,082	32,981	22,781	29,209	26,420	24,652
R-squared	0.614	0.602	0.752	0.919	0.902	0.889	0.757

This table presents the results of estimating our regression equation using SOI zip code Data using *ΔETR* as the dependent variable and Democratic (*Blue*) states as our variable of interest across the 2017 and 2018 tax years. This table estimates our regression equation across all *possible* zip codes where assets sales could take place. A *possible* business-owner zip code has a non-zero number of tax returns with business/professional income (N00900), partnership/S corporation net income (N26270), and capital gains/losses (N01000). Column (1) estimates the regression equation on all tax return zip codes. Column (2) estimates it for AGIs above $200K, while Columns (3) through (7) decrease in AGI_STUB.

We exclude change controls for the tax return line items for parsimony.

***, **, * indicate significance at the one percent, five percent, and ten percent levels, respectively.Continuous variables are winsorized at 1%/99%. Variables are defined in the Appendix.

Table 3: SOI Changes Analysis
***Likely* Business-Owner Zip Codes Partitioned by Adjusted Gross Income (AGI)**

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Dependent Variable: *ΔETR*	**Coefficient** ***(p-value)***	**Coefficient** ***(p-value)***	**Coefficient** ***(p-value)***	**Coefficient** ***(p-value)***	**Coefficient** ***(p-value)***	**Coefficient** ***(p-value)***	**Coefficient** ***(p-value)***
AGI Partition	**ALL**	**> $200K**	**$100K–$200K**	**$75K–$100K**	**$50K–$75K**	**$25K–$50K**	**< $25K**
*Post-TCJA * Blue*	0.002***	0.001***	0.002***	0.001***	−0.000	−0.000**	−0.000
	(0.000)	***(0.000)***	***(0.000)***	***(0.000)***	***(0.400)***	***(0.035)***	***(0.540)***
Post-TCJA	−0.024***	−0.030***	−0.020***	−0.018***	−0.014***	−0.011***	−0.007***
	(0.000)	***(0.000)***	***(0.000)***	***(0.000)***	***(0.000)***	***(0.000)***	***(0.000)***
Blue	0.000**	0.000*	0.000***	0.000***	−0.000	−0.000	−0.000
	(0.022)	***(0.074)***	***(0.000)***	***(0.000)***	***(0.941)***	***(0.413)***	***(0.114)***
Δ Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	79,316	20,574	29,412	13,952	9,924	3,565	1,889
R-squared	0.603	0.579	0.732	0.907	0.848	0.784	0.600

This table presents the results of estimating our regression equation using SOI zip code Data using *ΔETR* as the dependent variable and Democratic (*Blue*) states as our variable of interest across the 2017 and 2018 tax years. This table estimates our regression equation across all *likely* zip codes where asset sales could take place. A *likely* business-owner zip code has an above median percentage of tax returns with business/professional income (N00900), partnership/S corporation net income (N26270), and capital gains/losses (N01000). Column (1) estimates the regression equation on all tax return zip codes. Column (2) estimates it for AGIs above $200K, while Columns (3) through (7) decrease in AGI_STUB.
We exclude change controls for the tax return line items for parsimony.
***, **, * indicate significance at the one percent, five percent, and ten percent levels, respectively.Continuous variables are winsorized at 1%/99%. Variables are defined in Appendix.

returns before and after the enactment of the TCJA in high- and low-tax states across different entity types and income levels. Our simulations include a similarly-situated business owner in two different high-individual-income tax states (New York and California) and two different states with no individual income taxes (Texas and Florida).[99] We prepare before-and-after scenarios for business owners at three different levels of ordinary income—low ($80,000), medium ($160,000) and high ($750,000). We hold the filing status constant as married filing jointly and do not include any other dependents for all simulated individual taxpayer returns. Each of these simulations guides our analysis by identifying how implementation of the SALT deduction limitation impacts business owners depending on their individual circumstances.

We conduct our simulations based on taxpayer owners with total income from their business of $80,0000, $160,000, and $750,000, respectively, to assess the impacts on business owners within a low, medium and high tax bracket. This income is divided 50-50 with half classified as salary and the other half classified as profits of the business, a necessary distinction for purposes of FICA, SECA and NIIT.[100]

Because personal taxpayer attributes also impact the SALT deduction on business income, we carefully establish such attributes based on data from the IRS and national and state averages for realism and comparability. We hold the filing status constant as married filing jointly and do not include any other dependents for all simulated individual taxpayer returns. We establish personal residence values because the SALT deduction contemplates not only taxes paid on business income at the state level, but also personal property taxes paid. For comparability, we set home values at a constant of 3.45 times each taxpayer's total income and then apply the average property tax rate by state to determine property tax amounts. We also calculate a mortgage interest deduction using the five-year average APR for 30-year fixed mortgages. We then use IRS SOI data to identify realistic amounts for additional itemized deduction categories unrelated to personal residences based on

---

99. While property taxes and sales taxes exist in many states without income taxes, the differential arising from income taxes alone effectively categorizes these groupings as "high-tax" and "low-tax" states for purposes of the SALT deduction.

100. John Treu, *Less Is More: Applying A Modified Reasonable Compensation Standard to Eliminate the Inconsistencies in the Payroll and Net Investment Income Tax Bases*, 92 Neb. L. Rev. 586 (2014).

averages from actual taxpayers by AGI level and state of residence in the respective income ranges.[101] These additional itemized deduction categories include medical expenses, charitable contributions, miscellaneous deductions and other itemized deductions.

We prepare the tax returns for each of the simulated taxpayer scenarios using Intuit Pro-Connect© tax preparation software. Graduate students with experience in tax compliance practice provided feedback and assisted in the initial tax return preparation. We then had CPAs with tax compliance experience at Big Four and large national accounting firms review the tax returns for accuracy. We revised the simulated tax returns based on guidance received throughout this review process.

B. Simulation Results Comparing Multiple Income Levels and Different Entity Types Across High- and Low-Tax States Indicate that Adverse Impacts of SALT Cap are Primarily Among High-Income Taxpayers

Our first series of simulated returns contemplates a business that is taxed as a C corporation. As is the case for each of our scenarios, we consider the change in a business owner's overall ETR from tax year 2017 (pre-TCJA) to 2018 (post-TCJA) under different scenarios including four different states and at three different income levels. The SALT cap does not factor into this analysis as C corporations are permitted to deduct all state taxes paid in both simulated years, but this analysis provides a baseline for factors impacting entity choice for taxpayers in these income ranges. Our analysis presumes that C corporation profits after taxes are paid out as qualified dividends to the business owner and so the ETR reflects both the corporate tax as well as the individual business owner's income taxes as well as SECA and net investment income taxes. Figure 1 reports the results of the C corporation simulated returns.

We do not observe any obvious patterns in terms of the impact of the TCJA on the ETRs of C corporation business owners in the high-tax states versus the low-tax states, which is consistent with our expectation. We note that the low- and medium-income taxpayer businesses

101. We used data from the 2016 tax year, which was the most recently available data as of the time we prepared the simulations. *See* IRS., *SOI Tax Stats—Individual Statistical Tables by Size of Adjusted Gross Income*, https://www.irs.gov/statistics/soi-tax-stats-individual-statistical-tables-by-size-of-adjusted-gross-income [https://perma.cc/V89G-GYEM].

Figure 1: C Corporation at Simulated Income Levels

State	Tax Year	Individual Taxable Income	*Federal Entity Tax*	*State Entity Tax*	*Individual Federal Tax*	*AMT*	*Individual State Tax*	Total Tax	ETR	Change from 2017 to 2018
Panel A: Low Income ($80,000)										
CA	2017	$ 49,664	*$ 6,000*	*$ 3,536*	*$ 1,951*	*$ -*	*$ 1,264*	**$ 12,751**	15.94%	2.39%
CA	2018	$ 44,064	*$ 8,400*	*$ 3,536*	*$ 1,603*	*$ -*	*$ 1,123*	**$ 14,662**	18.33%	
NY	2017	$ 48,319	*$ 6,000*	*$ 2,600*	*$ 1,693*	*$ -*	*$ 2,891*	**$ 13,184**	16.48%	2.68%
NY	2018	$ 45,000	*$ 8,400*	*$ 2,600*	*$ 1,603*	*$ -*	*$ 2,724*	**$ 15,327**	19.16%	
FL	2017	$ 53,200	*$ 6,000*	*$ -*	*$ 1,951*	*$ -*	*$ -*	**$ 7,951**	9.94%	2.57%
FL	2018	$ 47,600	*$ 8,400*	*$ -*	*$ 1,603*	*$ -*	*$ -*	**$ 10,003**	12.50%	
TX	2017	$ 52,432	*$ 6,000*	*$ -*	*$ 1,843*	*$ -*	*$ -*	**$ 7,843**	9.80%	2.70%
TX	2018	$ 47,600	*$ 8,400*	*$ -*	*$ 1,603*	*$ -*	*$ -*	**$ 10,003**	12.50%	
Panel B: Medium Income ($160,000)										
CA	2017	$ 104,204	*$ 15,450*	*$ 7,072*	*$ 10,330*	*$ -*	*$ 5,435*	**$ 38,287**	23.93%	1.28%
CA	2018	$ 111,294	*$ 16,800*	*$ 7,072*	*$ 11,360*	*$ -*	*$ 5,095*	**$ 40,327**	25.20%	
NY	2017	$ 99,625	*$ 15,450*	*$ 5,200*	*$ 8,675*	*$ -*	*$ 7,161*	**$ 36,486**	22.80%	2.51%
NY	2018	$ 112,827	*$ 16,800*	*$ 5,200*	*$ 11,548*	*$ -*	*$ 6,958*	**$ 40,506**	25.32%	
FL	2017	$ 112,967	*$ 15,450*	*$ 1,650*	*$ 12,146*	*$ -*	*$ -*	**$ 29,246**	18.28%	1.00%
FL	2018	$ 117,550	*$ 16,800*	*$ 1,650*	*$ 12,395*	*$ -*	*$ -*	**$ 30,845**	19.28%	
TX	2017	$ 107,445	*$ 15,450*	*$ 2,250*	*$ 10,583*	*$ -*	*$ -*	**$ 28,283**	17.68%	1.72%
TX	2018	$ 115,777	*$ 16,800*	*$ 2,250*	*$ 11,991*	*$ -*	*$ -*	**$ 31,041**	19.40%	
Panel C: High Income ($750,000)										
CA	2017	$ 457,057	*$ 127,500*	*$ 33,150*	*$ 120,231*	*$ 23,797*	*$ 41,510*	**$ 322,391**	42.99%	-7.08%
CA	2018	$ 549,386	*$ 78,750*	*$ 33,150*	*$ 111,339*	*$ -*	*$ 46,028*	**$ 269,267**	35.90%	
NY	2017	$ 447,538	*$ 127,500*	*$ 24,375*	*$ 121,931*	*$ 29,484*	*$ 37,013*	**$ 310,819**	41.44%	-7.17%
NY	2018	$ 558,161	*$ 78,750*	*$ 24,375*	*$ 113,424*	*$ -*	*$ 40,506*	**$ 257,055**	34.27%	
FL	2017	$ 506,704	*$ 127,500*	*$ 17,875*	*$ 125,477*	*$ 12,455*	*$ -*	**$ 270,852**	36.11%	-7.88%
FL	2018	$ 564,661	*$ 78,750*	*$ 17,875*	*$ 115,131*	*$ -*	*$ -*	**$ 211,756**	28.23%	
TX	2017	$ 480,845	*$ 127,500*	*$ 20,522*	*$ 123,687*	*$ 20,115*	*$ -*	**$ 271,709**	36.23%	-7.72%
TX	2018	$ 562,014	*$ 78,750*	*$ 20,522*	*$ 114,501*	*$ -*	*$ -*	**$ 213,773**	28.50%	

taxed as C corporations in all simulated states experience an increase in ETRs under the TCJA with these increases ranging from 1.00% to as high as 2.70%, which primarily arises from the change to a flat 21% corporate tax rate. In the pre-TCJA period, corporate income below $50,000 was taxed at 15% and so C corporation taxpayers with corporate taxable income of $40,000 and $80,000 had increased ETRs overall under the TCJA as the first dollars earned are taxed at higher rates. For similar reasons, albeit in reverse, simulated high income C corporation business owners experienced dramatically lower ETRs following the TCJA with reductions in the range of 7.08 to 7.72%. While the impact of the TCJA primarily benefitted high income C corporations, C corporation filers are far less common at lower income levels where flowthrough entity structures tend to dominate.

Our second series of simulated returns contemplates an S corporation that is taxed as a flowthrough entity and its owner. As a flowthrough, there are no entity level income taxes at the federal level, although some states have franchise taxes and other entity level assessments. Individual income and SECA taxes are included in the calculation as well to provide a realistic picture of the overall change in ETRs. Figure 2 reports the results of the S corporation returns.

Every scenario in this second series experiences a reduction in its respective ETRs, and these reductions were driven by lower individual tax rates at all income levels and the qualified business income deduction that was introduced as part of the TCJA. It is also noteworthy that at the highest income level the simulated taxpayers are no longer subject to the Pease limitation in the post-TCJA period, which can diminish the actual impact of any SALT deduction irrespective of whether the SALT cap is in place.[102] Low-income simulated taxpayers were also favorably impacted by the increase in the standard deduction amount and one simulated high-income taxpayer was favorably impacted by the increase to the AMT exemption amount, but AMT was not a major factor in the simulated return scenarios reflected in Figure 2.

We next turn our attention to our primary research task: an analysis of the comparative impact of the TCJA on business owners in

---

102. Jared Walczak, *How the State and Local Tax Deduction Interacts with the AMT and Pease Limitation*, Tax Foundation (November 6, 2017), https://taxfoundation.org/state-and-local-tax-deduction-amt-pease/ [https://perma.cc/MYV6-YFGT].

Figure 2: S Corporation at Standard Income Levels

State	Tax Year	Individual Taxable Income	*Federal Entity Tax*	*State Entity Tax*	*Individual Federal Tax*	*AMT*	*Individual State Tax*	Total Tax	ETR	Change from 2017 to 2018
Panel A: Low Income ($80,000)										
CA	2017	$ 58,400	*$ -*	*$ 800*	*$ 7,831*	*$ -*	*$ 1,773*	**$ 10,404**	13.01%	-3.30%
CA	2018	$ 47,200	*$ -*	*$ 800*	*$ 5,286*	*$ -*	*$ 1,680*	**$ 7,766**	9.71%	
NY	2017	$ 56,083	*$ -*	*$ 300*	*$ 7,479*	*$ -*	*$ 3,427*	**$ 11,206**	14.01%	-2.70%
NY	2018	$ 47,700	*$ -*	*$ 300*	*$ 5,346*	*$ -*	*$ 3,402*	**$ 9,048**	11.31%	
FL	2017	$ 59,200	*$ -*	*$ -*	*$ 7,951*	*$ -*	*$ -*	**$ 7,951**	9.94%	-3.21%
FL	2018	$ 48,000	*$ -*	*$ -*	*$ 5,382*	*$ -*	*$ -*	**$ 5,382**	6.73%	
TX	2017	$ 58,372	*$ -*	*$ -*	*$ 7,824*	*$ -*	*$ -*	**$ 7,824**	9.78%	-3.05%
TX	2018	$ 48,000	*$ -*	*$ -*	*$ 5,382*	*$ -*	*$ -*	**$ 5,382**	6.73%	
Panel B: Medium Income ($160,000)										
CA	2017	$ 123,593	*$ -*	*$ 1,200*	*$ 22,376*	*$ -*	*$ 7,423*	**$ 30,999**	19.37%	-3.01%
CA	2018	$ 117,682	*$ -*	*$ 1,200*	*$ 17,769*	*$ -*	*$ 7,209*	**$ 26,178**	16.36%	
NY	2017	$ 117,810	*$ -*	*$ 1,000*	*$ 20,930*	*$ -*	*$ 8,681*	**$ 30,611**	19.13%	-2.04%
NY	2018	$ 117,882	*$ -*	*$ 1,000*	*$ 17,813*	*$ -*	*$ 8,537*	**$ 27,350**	17.09%	
FL	2017	$ 130,044	*$ -*	*$ -*	*$ 23,989*	*$ -*	*$ -*	**$ 23,989**	14.99%	-3.57%
FL	2018	$ 120,000	*$ -*	*$ -*	*$ 18,279*	*$ -*	*$ -*	**$ 18,279**	11.42%	
TX	2017	$ 122,950	*$ -*	*$ 2,250*	*$ 22,215*	*$ -*	*$ -*	**$ 24,465**	15.29%	-2.92%
TX	2018	$ 116,632	*$ -*	*$ 2,250*	*$ 17,538*	*$ -*	*$ -*	**$ 19,788**	12.37%	
Panel C: High Income ($750,000)										
CA	2017	$ 601,947	*$ -*	*$ 5,625*	*$ 197,665*	*$ -*	*$ 58,229*	**$ 261,519**	34.87%	-3.73%
CA	2018	$ 582,595	*$ -*	*$ 5,625*	*$ 170,260*	*$ -*	*$ 57,641*	**$ 233,526**	31.14%	
NY	2017	$ 591,733	*$ -*	*$ 3,750*	*$ 198,034*	*$ 4,139*	*$ 47,321*	**$ 249,105**	33.21%	-3.59%
NY	2018	$ 584,470	*$ -*	*$ 3,750*	*$ 170,987*	*$ -*	*$ 47,442*	**$ 222,179**	29.62%	
FL	2017	$ 658,374	*$ -*	*$ -*	*$ 221,322*	*$ -*	*$ -*	**$ 221,322**	29.51%	-6.49%
FL	2018	$ 588,220	*$ -*	*$ -*	*$ 172,631*	*$ -*	*$ -*	**$ 172,631**	23.02%	
TX	2017	$ 614,104	*$ -*	*$ 20,522*	*$ 203,011*	*$ -*	*$ -*	**$ 223,533**	29.80%	-7.06%
TX	2018	$ 567,698	*$ -*	*$ 20,522*	*$ 150,073*	*$ -*	*$ -*	**$ 170,595**	22.75%	

high- and low-tax states based on the SALT cap. It is important to consider the changes in ETRs because various factors unrelated to the SALT cap can impact ETRs, but these same factors are relevant to its true impact. Differences in the underlying state tax rates exist in both the pre- and post-TCJA periods and so an analysis of the change in the overall ETRs paints the most complete picture of the actual impact of the TCJA. Hence, we next consider the average change in ETR in the pre- and post-TCJA periods for low-tax states compared to high-tax states and also consider the average change in the overall advantage of being a C corporation versus an S corporation at each income level. Figure 3

Figure 3: Summary of Changes in ETRs at Standard Income Levels

C Corp / S Corp	High-Tax State	ETR	Change from 2017 to 2018	Low-Tax State	ETR	Change from 2017 to 2018	*Average (High) - Low Advantage*
Panel A: Low Income ($80,000)							
C Corp	CA	15.94%	2.39%	FL	9.94%	2.57%	*-0.10%*
C Corp	CA	18.33%		FL	12.50%		
C Corp	NY	16.48%	2.68%	TX	9.80%	2.70%	
C Corp	NY	19.16%		TX	12.50%		
S Corp	CA	13.01%	-3.30%	FL	9.94%	-3.21%	*0.13%*
S Corp	CA	9.71%		FL	6.73%		
S Corp	NY	14.01%	-2.70%	TX	9.78%	-3.05%	
S Corp	NY	11.31%		TX	6.73%		
Average (C Corp) - S Corp Advantage			*5.53%*			*5.76%*	
Panel B: Medium Income ($160,000)							
C Corp	CA	23.93%	1.28%	FL	18.28%	1.00%	*0.53%*
C Corp	CA	25.20%		FL	19.28%		
C Corp	NY	22.80%	2.51%	TX	17.68%	1.72%	
C Corp	NY	25.32%		TX	19.40%		
S Corp	CA	19.37%	-3.01%	FL	14.99%	-3.57%	*0.72%*
S Corp	CA	16.36%		FL	11.42%		
S Corp	NY	19.13%	-2.04%	TX	15.29%	-2.92%	
S Corp	NY	17.09%		TX	12.37%		
Average (C Corp) - S Corp Advantage			*4.42%*			*4.61%*	
Panel C: High Income ($750,000)							
C Corp	CA	42.99%	-7.08%	FL	36.11%	-7.88%	*0.68%*
C Corp	CA	35.90%		FL	28.23%		
C Corp	NY	41.44%	-7.17%	TX	36.23%	-7.72%	
C Corp	NY	34.27%		TX	28.50%		
S Corp	CA	34.87%	-3.73%	FL	29.51%	-6.49%	*3.11%*
S Corp	CA	31.14%		FL	23.02%		
S Corp	NY	33.21%	-3.59%	TX	29.80%	-7.06%	
S Corp	NY	29.62%		TX	22.75%		
Average (C Corp) - S Corp Advantage			*-3.46%*			*-1.03%*	

provides this analysis building on the scenarios displayed in Figures 1 and 2 (the C corporation and S corporation scenarios, respectively).

The results from these figures paint a mixed picture of the overall impact of the TCJA on simulated business owners arising from the SALT deduction limitation. The average advantage for low-tax states across most simulations is relatively small, particularly in comparison to the much more significant underlying differences in income tax rates at the state level. In fact, the low-income C corporation owners in high-tax states actually saw, on average, a smaller increase in taxes than the C corporation business owners in low-tax states, but the advantage was a mere one tenth of a percent. In fact, when stacking high-tax states against low-tax states, the difference in the change in tax rate was less than one percent for all simulated C corporation owners and for all taxpayers, regardless of entity type, in the low and medium income scenarios. The only scenario with a decided advantage between high-tax and low-tax states was the S corporation owner scenarios at the highest level of income.

High-income owners in low-tax states gained a 3.11% comparative advantage in ETRs, on average, over similarly situated owners in high-tax states. This result arises primarily from the SALT cap, which makes sense given that most of these simulated taxpayers did not incur AMT and, as such, the SALT cap would be expected have the greatest impact.

C. Simulation Results with Additional Income and Variations in Long-Term Capital Gain Amounts Suggest Impact of SALT Cap is Nuanced Even Among High-Income Taxpayers

Taken together, it appears the imposition of the SALT deduction limitation has a relatively small impact on the comparative ETRs for most simulated taxpayers in high- and low-tax states. A notable exception applies for taxpayers with S corporation businesses that incur high levels of income. Limitations of our initial analysis, however, are that we do not take capital gains income into account and we do not consider impacts for taxpayers at higher levels of income. Capital gains income is critical to this analysis both because it is more common for high-income taxpayers to generate capital gains and because significant capital gain income can trigger AMT by reducing the AMT credit that diminishes or eliminates the impact of the SALT cap.[103]

---

103. § 56(b)(1)(A)(ii); Linda Beale, *Congress Fiddles While Middle America Burns: Amending the AMT (And Regular Tax)*, 6 Fla. Tax Rev. 811,

For these reasons, we conduct further analysis at three new "higher" income levels.

We begin with our initial ordinary income cases of $80,000, $160,000 and $750,000 for each taxpayer owner and then incorporate additional income of $152,000, $780,000 and $24,000,000. This results in total income of $232,000 for our "low" income taxpayer, total income of $940,000 for our medium income taxpayer, and $23,488,000 for our high-income taxpayer.[104] The Pease limitation is very much in effect for the medium- and high-level taxpayers, suggesting that SALT deductions in the pre-TCJA period were already facing some degree of limitation.[105] We then run simulations with this additional income classified as either all long-term capital gain income or divided 50-50 as ordinary income and long-term capital gain income.

Our first series of simulated tax returns is based on the scenario where the additional income exclusively arises from long-term capital gains. We present specific detailed results of the simulated returns from this first scenario in Figure 4 below. We note that AMT greatly impacts the high-income taxpayers that have large amounts of capital gains, with six of the eight simulated taxpayers incurring AMT. Even though capital gains receive preferential rates under AMT,[106] this result is understandable because long-term capital gains are included in total income for purposes of calculating the AMT exemption and, as such, capital gain can indirectly trigger AMT.[107] Importantly, the impact of the SALT cap on the ETRs of these high-income taxpayers with large capital gains is severely diminished, which further suggests that the SALT cap

---

813 (2004); URBAN INST. & BROOKINGS INST., *The Tax Policy Center's Briefing Book: The State of State (and Local) Tax Policy*, https://www.taxpolicycenter.org/briefing-book/how-does-deduction-state-and-local-taxes-work [https://perma.cc/UK7C-VH37]; Walczak, *supra* note 102.

104. Because our additional analysis is focused on taxpayers with capital gains, we set these additional income levels using the 25th, 50th and 75th percentiles for sales prices less average basis for flowthrough entities based on transactions included in the DealStats database from Business Valuation Resources over the four-year period from 2016 to 2019. *DealStats* (previously called *Pratt's Stats)* provides data on public and private acquisitions of public and private targets.

105. Walczak, *supra* note 102.

106. § 55(b)(3).

107. Beale, *supra* note 103, at 813; Christopher Hanna, *The Magic in the Tax Legislative Process*, 59 SMU L. Rev. 649, 670 n.111 (2006).

Figure 4: S Corporation with Additional Income (Capital Gain Only)

State	Tax Year	Total Income (including Gains)	*State Entity Tax*	*Individual Federal Tax*	*AMT*	*Individual State Tax*	Total Tax	ETR	Change from 2017 to 2018
Panel A: Total Income of $232,000 - Low Income ($80,000) & Capital Gain ($152,000)									
CA	2017	$ 210,400	*$ 800*	*$ 24,410*	N	*$ 15,096*	**$ 40,306**	17.37%	-0.45%
CA	2018	$ 199,200	*$ 800*	*$ 23,586*	N	*$ 14,882*	**$ 39,268**	16.93%	
NY	2017	$ 208,083	*$ 300*	*$ 24,079*	N	*$ 14,341*	**$ 38,720**	16.69%	-0.23%
NY	2018	$ 199,700	*$ 300*	*$ 23,721*	N	*$ 14,168*	**$ 38,189**	16.46%	
FL	2017	$ 211,200	*$ -*	*$ 28,246*	N	*$ -*	**$ 28,246**	12.18%	-1.92%
FL	2018	$ 200,000	*$ -*	*$ 23,802*	N	*$ -*	**$ 23,802**	10.26%	
TX	2017	$ 210,372	*$ -*	*$ 27,844*	N	*$ -*	**$ 27,844**	12.00%	-1.74%
TX	2018	$ 200,000	*$ -*	*$ 23,802*	N	*$ -*	**$ 23,802**	10.26%	
Panel B: Total Income of $940,000 - Medium Income ($160,000) & Capital Gain ($780,000)									
CA	2017	$ 903,593	*$ 1,200*	*$ 198,632*	Y	*$ 87,708*	**$ 287,540**	30.59%	-1.86%
CA	2018	$ 897,572	*$ 1,200*	*$ 181,855*	N	*$ 86,991*	**$ 270,046**	28.73%	
NY	2017	$ 897,810	*$ 1,000*	*$ 200,551*	Y	*$ 63,222*	**$ 264,773**	28.17%	-1.98%
NY	2018	$ 897,772	*$ 1,000*	*$ 181,917*	N	*$ 63,222*	**$ 246,139**	26.19%	
FL	2017	$ 910,044	*$ -*	*$ 207,650*	Y	*$ -*	**$ 207,650**	22.09%	-2.67%
FL	2018	$ 900,000	*$ -*	*$ 182,549*	N	*$ -*	**$ 182,549**	19.42%	
TX	2017	$ 902,950	*$ 2,250*	*$ 206,868*	Y	*$ -*	**$ 209,118**	22.25%	-2.70%
TX	2018	$ 896,522	*$ 2,250*	*$ 181,531*	N	*$ -*	**$ 183,781**	19.55%	
Panel C: Total Income of $23,488,000 - High Income ($750,000) & Capital Gain ($22,738,000)									
CA	2017	$ 23,339,947	*$ 5,625*	*$ 5,480,207*	Y	*$ 3,081,866*	**$ 8,567,698**	36.48%	0.45%
CA	2018	$ 23,391,727	*$ 5,625*	*$ 5,587,615*	Y	*$ 3,080,500*	**$ 8,673,740**	36.93%	
NY	2017	$ 23,329,733	*$ 3,750*	*$ 5,518,384*	Y	*$ 2,069,895*	**$ 7,592,029**	32.32%	0.30%
NY	2018	$ 23,318,602	*$ 3,750*	*$ 5,588,212*	Y	*$ 2,069,895*	**$ 7,661,857**	32.62%	
FL	2017	$ 23,396,374	*$ -*	*$ 5,660,497*	N	*$ -*	**$ 5,660,497**	24.10%	-0.30%
FL	2018	$ 23,322,352	*$ -*	*$ 5,589,778*	Y	*$ -*	**$ 5,589,778**	23.80%	
TX	2017	$ 23,352,104	*$ 20,522*	*$ 5,649,758*	N	*$ -*	**$ 5,670,280**	24.14%	-0.28%
TX	2018	$ 23,301,830	*$ 20,522*	*$ 5,583,251*	Y	*$ -*	**$ 5,603,773**	23.86%	

impacts are nuanced, even among high-income business owners. Also, all of the medium-income taxpayers under this scenario trigger AMT in 2017 but not in 2018, consistent with taxpayers at these income levels benefiting from the AMT exemption increase under the TCJA.

Our second series of simulated tax returns splits the additional income as half long-term capital gain and the other half ordinary income. Because we started with base ordinary income, we end up with just over half of each simulated taxpayer's total income classified as ordinary income. We present specific detailed results of these simulated returns in Figure 5.

We note that AMT is not a major factor for most simulated taxpayers in this scenario with higher levels of ordinary income and our results for this grouping of taxpayers appear to approximately align with the scenario for high-income taxpayers without any capital gains.

We return to our primary research question of the comparative impact of the TCJA and SALT cap on business owners in high- and low-tax states for both additional income scenarios. As always, we note that various factors unrelated to the SALT cap can impact ETRs and differences in the underlying tax rates exist in both the pre- and post-TCJA periods. Figure 6 provides the comparative advantage in the change in ETRs at each income level where all additional income is long term capital gain and Figure 7 provides this same detail where the additional income is split 50-50 as capital gain income and ordinary income

In the capital gain-only scenario displayed in Figure 6, we observe that all low-tax state taxpayers fared better on average under the TCJA change than similarly situated taxpayers in high-tax states although, interestingly, this advantage diminishes as income increases. The lowest-income taxpayer advantage was 1.49% whereas the highest-income taxpayer advantage was only .67%, with the medium-income taxpayer advantage in between these percentages. This phenomenon occurs because AMT has an increasing impact at higher income levels for taxpayers with significant capital gains, thereby diminishing the impact of the SALT cap for this subset of taxpayers.

The low-tax state taxpayers in the scenario where additional income is split 50-50 as capital gains and ordinary income also consistently fared better on average than the high-tax state taxpayers as reflected in Figure 7. The trend reverses, however, where there are large amounts of ordinary income, with the highest income levels receiving the greatest benefit (a 3.63% advantage) and the low income levels receiving the least benefit (1.23%). AMT doesn't play as great a role under

Figure 5: S Corporation with Additional Income (Split 50-50 Between Capital Gain & Ordinary Income)

State	Tax Year	Total Income (including Gains)	*State Entity Tax*	*Individual Federal Tax*	*AMT*	*Individual State Tax*	Total Tax	ETR	Change from 2017 to 2018
Panel A: Total Income of $232,000 - Low Income ($80,000), Capital Gain ($76,000) & Ordinary Gain ($76,000)									
CA	2017	$ 210,400	*$ 800*	*$ 33,484*	N	*$ 15,096*	**$ 49,380**	21.28%	-1.43%
CA	2018	$ 199,200	*$ 800*	*$ 30,383*	N	*$ 14,882*	**$ 46,065**	19.86%	
NY	2017	$ 208,083	*$ 300*	*$ 33,208*	N	*$ 14,341*	**$ 47,849**	20.62%	-1.24%
NY	2018	$ 199,700	*$ 300*	*$ 30,493*	N	*$ 14,168*	**$ 44,961**	19.38%	
FL	2017	$ 211,200	*$ -*	*$ 36,678*	N	*$ -*	**$ 36,678**	15.81%	-2.64%
FL	2018	$ 200,000	*$ -*	*$ 30,559*	N	*$ -*	**$ 30,559**	13.17%	
TX	2017	$ 210,372	*$ -*	*$ 36,344*	N	*$ -*	**$ 36,344**	15.67%	-2.49%
TX	2018	$ 200,000	*$ -*	*$ 30,559*	N	*$ -*	**$ 30,559**	13.17%	
Panel B: Total Income of $940,000 - Medium Income ($390,000), Capital Gain ($390,000) & Ordinary Gain ($390,000)									
CA	2017	$ 903,593	*$ 1,200*	*$ 249,305*	Y	*$ 87,708*	**$ 338,213**	35.98%	-1.79%
CA	2018	$ 897,572	*$ 1,200*	*$ 233,203*	N	*$ 86,991*	**$ 321,394**	34.19%	
NY	2017	$ 897,810	*$ 1,000*	*$ 238,900*	Y	*$ 63,222*	**$ 303,122**	32.25%	-0.60%
NY	2018	$ 897,772	*$ 1,000*	*$ 233,281*	N	*$ 63,222*	**$ 297,503**	31.65%	
FL	2017	$ 910,044	*$ -*	*$ 262,222*	N	*$ -*	**$ 262,222**	27.90%	-2.99%
FL	2018	$ 900,000	*$ -*	*$ 234,099*	N	*$ -*	**$ 234,099**	24.90%	
TX	2017	$ 902,950	*$ 2,250*	*$ 261,246*	N	*$ -*	**$ 263,496**	28.03%	-3.03%
TX	2018	$ 896,522	*$ 2,250*	*$ 232,797*	N	*$ -*	**$ 235,047**	25.01%	
Panel C: Total Income of $23,488,000 - High Income ($750,000), Capital Gain ($11,369,000) & Ordinary Gain ($11,369,000)									
CA	2017	$ 23,339,947	*$ 5,625*	*$ 6,816,270*	N	*$ 3,081,866*	**$ 9,903,761**	42.17%	2.96%
CA	2018	$ 23,391,727	*$ 5,625*	*$ 7,512,522*	N	*$ 3,080,500*	**$ 10,598,647**	45.12%	
NY	2017	$ 23,329,733	*$ 3,750*	*$ 7,246,298*	N	*$ 2,069,895*	**$ 9,319,943**	39.68%	1.14%
NY	2018	$ 23,318,602	*$ 3,750*	*$ 7,513,288*	N	*$ 2,069,895*	**$ 9,586,933**	40.82%	
FL	2017	$ 23,396,374	*$ -*	*$ 7,888,442*	N	*$ -*	**$ 7,888,442**	33.58%	-1.59%
FL	2018	$ 23,322,352	*$ -*	*$ 7,515,191*	N	*$ -*	**$ 7,515,191**	32.00%	
TX	2017	$ 23,352,104	*$ 20,522*	*$ 7,877,703*	N	*$ -*	**$ 7,898,225**	33.63%	-1.58%
TX	2018	$ 23,301,830	*$ 20,522*	*$ 7,506,818*	N	*$ -*	**$ 7,527,340**	32.05%	

Figure 6: Summary of Changes in ETRs—Additional Income All Capital Gain

High-Tax State	ETR	Change from 2017 to 2018	Low-Tax State	ETR	Change from 2017 to 2018	*Average (High) - Low Advantage*
Panel A: Total Income of $232,000 - Low Income ($80,000) & Capital Gain ($152,000)						
CA	17.37%	-0.45%	FL	12.18%	-1.92%	***1.49%***
CA	16.93%		FL	10.26%		
NY	16.69%	-0.23%	TX	12.00%	-1.74%	
NY	16.46%		TX	10.26%		
Panel B: Total Income of $940,000 - Medium Income ($160,000) & Capital Gain ($780,000)						
CA	30.59%	-1.86%	FL	22.09%	-2.67%	***0.76%***
CA	28.73%		FL	19.42%		
NY	28.17%	-1.98%	TX	22.25%	-2.70%	
NY	26.19%		TX	19.55%		
Panel C: Total Income of $23,488,000 - High Income ($750,000) & Capital Gain ($22,738,000)						
CA	36.48%	0.45%	FL	24.10%	-0.30%	***0.67%***
CA	36.93%		FL	23.80%		
NY	32.32%	0.30%	TX	24.14%	-0.28%	
NY	32.62%		TX	23.86%		

Figure 7: Summary of Changes in ETRs—Additional Income Split 50-50 Between Capital Gain & Ordinary Income

High-Tax State	ETR	Change from 2017 to 2018	Low-Tax State	ETR	Change from 2017 to 2018	*Average (High) - Low Advantage*
Panel A: Total Income of $232,000 - Low Income ($80,000), Capital Gain ($76,000) & Ordinary Gain ($76,000)						
CA	21.28%	-1.43%	FL	15.81%	-2.64%	***1.23%***
CA	19.86%		FL	13.17%		
NY	20.62%	-1.24%	TX	15.67%	-2.49%	
NY	19.38%		TX	13.17%		
Panel B: Total Income of $940,000 - Medium Income ($390,000), Capital Gain ($390,000) & Ordinary Gain ($390,000)						
CA	35.98%	-1.79%	FL	27.90%	-2.99%	***1.82%***
CA	34.19%		FL	24.90%		
NY	32.25%	-0.60%	TX	28.03%	-3.03%	
NY	31.65%		TX	25.01%		
Panel C: Total Income of $23,488,000 - High Income ($750,000), Capital Gain ($11,369,000) & Ordinary Gain ($11,369,000)						
CA	42.17%	2.96%	FL	33.58%	-1.59%	***3.63%***
CA	45.12%		FL	32.00%		
NY	39.68%	1.14%	TX	33.63%	-1.58%	
NY	40.82%		TX	32.05%		

this scenario, and so these simulations are consistent with the results for S corporations reflected in Figure 3.

Taken together, it appears the imposition of the SALT deduction limitation has a relatively small impact on the comparative ETRs for most simulated taxpayers in high- and low-tax states, with the notable exception being S corporation businesses generating high levels of ordinary income.

V. Conclusion

Our study partially answers Joel Slemrod's call for research on the TCJA's effects on business investment.[108] Additionally, ours is the first study of which we are aware to explore empirically the economic impacts of the SALT limitation on business owners. We exploit aggregated taxpayer data and a series of simulated tax returns before and after the passage of the TCJA to determine how the SALT deduction cap impacts the ETRs of business owners in high- and low-tax states. Small business owners in high-tax states worry that the SALT deduction limitation unfairly penalizes them. However, our modeled and empirical findings reveal that the SALT cap penalty is nuanced and localized among high income taxpayers with primarily ordinary income as opposed to capital gains income. These findings provide clear and important evidence to policy makers and commentators who are considering the future of the state and local tax deduction.

First, the actual impact of the SALT cap appears to be less pronounced than many policy discussions in blue states might lead one to believe. Specifically, we find that business owners at low- and medium-income levels in high-tax states are not significantly impacted by the SALT cap, regardless of entity type, because these business owners benefit from the higher standard deduction under the TCJA. Also, even when medium-income business owners itemize, their deduction amounts are close enough to the standard deduction and they also pay too little state and local taxes, on average, for the presence or elimination of the SALT cap to have a substantial impact on their ETRs one way or the other. As expected, business owners of companies that are taxed as C corporations in high-tax states at all income levels are not significantly

---

108. Joel Slemrod, *Tax Reform and Tax Experts*, 40 J. Am. Tax'n Ass'n 83 (2018); Joel Slemrod, *Is This Tax Reform, or Just Confusion?,* 32 J. Econ. Persp. 73 (2018).

disadvantaged by the SALT cap. Lastly, flowthrough business owners in high-tax states with high levels of capital gains income are only moderately disadvantaged by the SALT cap on average because AMT already limits the benefit that is otherwise available from SALT deductions irrespective of the SALT cap.

Flowthrough entity owners in high-tax states with high levels of ordinary income consistently face the most substantial disadvantage in ETRs compared to similarly situated business owners in low-tax states. This disadvantage was as high as 3.63% for our highest income simulated taxpayer earning $23,488,000.

Given the nuanced and reasonably small impact of the SALT cap on most businesses in high-tax states, policy makers and commentators should carefully consider whether the drastic changes to the structure of flowthrough entity taxation impacting all business owners are merited. These state-level workarounds may have been solutions in search of a problem. Inasmuch as most business owners are not significantly impacted by the SALT cap, efforts to craft state-level workarounds are likely imposing additional administrative costs on low and medium income businesses to achieve a benefit that inures only to a subset of high income businesses. Concerns over comparative disadvantages for small businesses could potentially be better addressed through targeted changes at the federal level.

Also, since the SALT cap was not as draconian as many suggested, a straight repeal of the SALT cap will not be as beneficial as many are selling it, particularly if the Pease limitation is re-introduced. If the primary concern is mitigating inequities between flowthrough and non-flowthrough entities with respect to the deductibility of state-level taxes, a credit could be offered to business owners that offsets the additional tax arising from non-deductible SALT on business-related income. Alternatively, if Congress wants to return the state and local tax deduction to its earlier prominence (and allow significantly more taxpayers to directly benefit from the allowance of it) then the repeal of the SALT cap alone is not enough. Policy makers should consider furthers steps such as classifying the deduction as nonitemized or allowing the deduction when determining income tax liability under the alternative minimum tax.

Appendix
Variable Definitions

Variable	Definition
Variable of Interest:	
Blue	1 if *Target State* is a "blue" state—defined as a state where the Democratic share of total votes was, on average, five percentage points higher than the Republican share of total votes over the past five presidential elections (Source: Altig et al. 2020).
SOI Variables:	
ΔETR	Change in ETR: Total tax liability amount (A10300) / AGI (A00100) from *y-1* to *y*.
ΔCapital Gains %	Change in capital gains (A01000) / AGI (A00100) from *y-1* to *y*.
ΔSchedule C %	Change in business or professional net income (A00900) / AGI (A00100) from *y-1* to *y*.
ΔSchedule E %	Change in partnership/S corporation net income (A26270) / AGI (A00100) from *y-1* to *y*.
ΔTotal Itemized Deductions %	Change in total itemized deductions (A04470) / AGI (A00100) from *y-1* to *y*.
ΔTotal Credits %	Change in total tax credits (A07100) / AGI (A00100) from *y-1* to *y*.
ΔInterest Income %	Change in taxable interest (A00300) / AGI (A00100) from *y-1* to *y*.
ΔOrdinary Dividend %	Change in ordinary dividends (A00600) / AGI (A00100) from *y-1* to *y*.
ΔQualified Dividend %	Change in qualified dividends (A00650) / AGI (A00100) from *y-1* to *y*.