The Future of SALT: A Broader Picture

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Recommended Citation
https://www.repository.law.indiana.edu/facpub/2686
The Future of SALT: A Broader Picture

by David Gamage and Darien Shanske

The federal tax system interacts with state systems in many ways, but the state and local tax deduction — one of the largest points of interface — is perhaps the most susceptible to direct analysis. There has been much theorizing as to how best to structure the SALT deduction. However, because of the limitations of tax politics, the assumption has long been that the SALT deduction could only be changed glacially or by subterfuge — or by both (consider the effects of the alternative minimum tax).

The 2017 federal tax legislation, however, changed the SALT deduction dramatically. Specifically, for taxpayers who still itemize, the deduction is now capped at $10,000 for a combination of property and income (or sales) taxes. Much of the critical attention has been on how states could and should respond to this cap — particularly those with many taxpayers who will pay more because of it. Here, we will consider the question from a somewhat different perspective. The changes to the SALT deduction indicate that further amendment might be possible. Indeed, to the extent that this change is unpopular in large parts of the county and set to expire, there will likely be another reform opportunity. We elect not to delve too deeply into why Congress passed the changes that it did, but as we will soon show, these changes are not consistent with any theory as to what the SALT deduction is or should be. To this end, we will canvas some such theories to consider how future reforms might proceed; inevitably, we will also offer thoughts on how SALT reform should have gone the first time.

Approach One:
Reform Based on Income Tax Principle

The SALT deduction is a long-standing component of the federal income tax, but its merits on income tax principles have long been contested. If state and local services represent a consumption good, such as paying for a fancy dinner, then there is no justification for the SALT deduction at all based on income tax principles. Indeed, this is why special benefit assessments, payments to governments for specific benefits, are not deductible. But if one conceives state and local taxes as a total loss, making the taxpayer

3 IRC 164(b)(6).
unambiguously worse off, then there is a good argument for the deduction on income tax grounds. Clearly, the truth is somewhere in between these two extremes.

Accordingly, one way to think of the new SALT cap is as though the federal government were asserting that anyone not taking the standard deduction or subject to the AMT should be credited with no more than $10,000 in taxes not levied to pay for a direct benefit. The problem here is that this articulation reveals the arbitrariness of the new SALT deduction cap, as judged by income tax principles.

By contrast, imagine that the federal limit had instead been set so that the federal deduction would be limited to 50 percent of taxes paid, with no cap. This change would also have been unpopular with many states, but such a change — because it is better aligned with income tax theory — would also have thrown less of a wrench in the tax system of many states.

Therefore, replacing the cap with an uncapped, percentage-limited deduction is one plausible option for future reform. A related alternative for future reform would be to permit a deduction for state — but not local — taxes, on the theory that local taxes more closely resemble a price paid for a particular bundle of goods.

Approach Two:
Stabilize State and Local Revenues

The federal SALT deduction cap primarily affects taxpayers who pay much more than $10,000 in state taxes. Looked at from this perspective, the new federal SALT deduction cap can arguably be viewed as specifically targeting states with both progressive income taxes and especially wealthy taxpayers — as this is what results in there being many taxpayers who pay much more than $10,000. Naturally, those states are upset with the new federal SALT deduction cap. But might the new cap nevertheless be justified as something more than representing dislike of progressive taxes or the states that levy them? One possible justification is based on the fact that progressive tax bases tend to be more volatile, and that the federal government has reason to want to reduce this fiscal volatility.

However, the federal SALT deduction cap is a very crude instrument for accomplishing this goal. First, many of the taxes implicated are local property taxes, which are the most stable in the state and local arsenal. If there is a concern with progressive income taxes and their volatility, then why cap property taxes?

Second, and more profoundly, the federal government has not reduced the fiscal burden on states and, if anything, has acted — and attempted to act — to dramatically increase that burden. Disfavoring a key element of many states’ revenue systems while increasing demands on those systems is a perverse attempt at limiting the harms from fiscal volatility.

Approach Three:
Improve Operation of the Overall Tax System

Perhaps the federal government does not care about state revenue stability and just thinks — with some justification — that high subnational personal income taxes are not a good idea. For instance, the federal government might believe that high state personal income taxes layered on top of federal personal income taxes cause taxpayers to engage in exponentially greater distortive behavior to avoid those taxes.

Yet capping the SALT deduction is, again, a very crude attempt to accomplish such a goal. First, as we have demonstrated elsewhere, the amount of distortion caused by state corporate income taxes is potentially much greater than that caused by state personal income taxes. More specifically, the distortion caused by the ordinary income component of state personal income taxes is relatively small compared with the distortions stemming from state capital gains taxes and

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2 Gladriel Shobe, Disaggregating the State and Local Tax Deduction, 35 Virginia Tax Review 327 (2016).


4 See Shanske supra at 426-29.

corporate income taxes.\textsuperscript{11} Thus, this rationale provides little justification for capping state-level ordinary income tax payments. Even more perversely, the continued deductibility of corporate income taxes means that the amended SALT deduction actually encourages states to rely more on a form of taxation that increases distortion.

If the federal government were really concerned about improving the overall functioning of the system of raising revenue, the clear prescription would be for it to adopt a credit-invoice VAT that the states could piggyback on.\textsuperscript{12} The primary hold up here seems to be purely political, which resulted in last year’s consideration of the destination-based cash flow tax. The designers of this complicated new tax were clear that it was intended to (in part) tax consumption like a VAT.\textsuperscript{13} So why not just impose a well-understood tax used in virtually every other country on earth?

Approach Four: Make the Federal Tax System More Progressive

As an itemized deduction, the SALT deduction disproportionately benefits wealthier taxpayers. Capping the deduction was therefore one of the more progressive components of an otherwise regressive legislative package. Of course, the package’s overall regressivity rules out progressivity as the reason the SALT deduction was capped, but this argument could motivate a future Congress and is certainly a legitimate consideration. Thus, capping the SALT deduction has the curious impact of making the federal system more progressive while putting lots of pressure on the states to be less progressive.

A more straightforward — if expensive — way to make the SALT deduction more progressive would be to expand its availability by making it into a credit or an above-the-line deduction (perhaps along with limiting the deduction or credit to only a percentage of taxes paid).\textsuperscript{14} This approach could encourage federalism by making state and local taxes less costly for a wider swath of taxpayers, which is another value that a future Congress could choose to encourage.

Conclusion

To review, here is a set of theoretically coherent, defensible, and some even mutually consistent approaches that the federal government could have taken — and may yet take — to reform the SALT deduction:

1. On income tax principles, make the deduction an uncapped percentage of state and local taxes paid.
2. To advance state revenue stability, make more stable state and local levies (especially property taxes) more deductible.
3. To improve the efficiency of the federal and state tax systems, the federal government could implement a national credit-invoice VAT that the states could supplement, thereby allowing states to abandon their much less efficient retail sales taxes. Reducing the SALT deduction could be used as a stick to get states to replace their less efficient taxes with more efficient alternatives.
4. To improve the efficiency of the federal and state tax systems, the federal government could discourage corporate income taxes in particular.
5. To make the SALT deduction more progressive and to reduce taxes for all state and local taxpayers, the federal government could make some portion of the SALT deduction an above-the-line deduction or a credit.

\textsuperscript{11} Id.
\textsuperscript{12} Id. at 363.
\textsuperscript{13} Alan J. Auerbach, Michael P. Devereux, Michael Keen, John Vella, “Destination-Based Cash Flow Taxation,” at *4, Oxford University Centre for Business Taxation (Feb. 6, 2017).
\textsuperscript{14} For example, in 2008-10, Congress permitted up to $1,000 (joint return) in property taxes to be deducted “above the line.” For some credit options, see Frank Sammartino and Kim Rueben, “Revisiting the State and Local Tax Deduction,” Tax Policy Center, Urban Institute & Brookings Institution, Mar. 31, 2016.