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Tax Policy

Recently enacted federal tax reform expands the standard deduction while limiting the deduction for state and local taxes. Many households will now be paying nondeductable state and local taxes, and may well resist state and local efforts to increase taxes for schools, hospitals, and other public services. In this article, Assistant Professor Daniel Hemel of the University of Chicago Law School discusses these issues and options for states and localities to offset the impact of federal tax reform.

States and Localities Can Offset Federal Tax Law's Impact on Their Residents

BY DANIEL HEMEL

The federal tax overhaul signed into law by President Trump last month strikes a blow to households in high-tax states, with potentially negative ramifications for state and local government finances. First, the law imposes a new $10,000 cap on the deduction for state and local taxes (SALT)—well below the average amount claimed by residents of high-tax states such as New York, California, and New Jersey. Second, the legislation rolls the preexisting law's personal exemptions into a much larger standard deduction, which will mean that most taxpayers who currently itemize their deductions will stop doing so and thus will lose any SALT benefit. The net effect will be that the vast majority of households pay their state and local taxes with nondeductible dollars—which, in turn, will make voters more likely to resist state and local tax increases and will make it harder for states and municipalities to raise revenue for their schools, hospitals, police and fire departments, and other vital public services.

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But states are not helpless in the face of the new SALT limits. One proposal, which the State of California and several towns in New Jersey are considering, would allow taxpayers to claim a state or local tax credit in exchange for donations to government-affiliated organizations such as public schools, hospitals, and police and fire departments. Because such donations are treated as charitable contributions rather than state and local tax payments for federal income tax purposes, these arrangements would allow taxpayers who hit the $10,000 SALT cap to satisfy their remaining state and local tax obligations with federally deductible dollars.

A second proposal—which is the focus of this report—would involve state and local governments shifting from employee-side personal income taxes to employer-side payroll taxes, which remain fully deductible for federal tax purposes. This payroll tax shift would deliver benefits for workers in states with high income taxes regardless of whether those workers itemize deductions on their federal tax returns. Importantly, the two proposals are not mutually exclusive, and states and localities would be well-advised to consider both.

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Proposals for a payroll tax shift stand on solid legal ground. And the administrative challenges of such a shift would be relatively easy to overcome. New York Governor Andrew Cuomo announced in his State of the State speech early this month that his administration is considering a proposal along these lines. And as the federal tax benefits of such a shift become apparent, look for more states to follow suit.

How It Would Work

To see how the payroll tax shift might work, imagine a state with a flat tax on income of 5%. Currently, when an employer pays an additional $100 to an employee, $5 goes to the state and $95 goes to the employee (before subtracting federal taxes). If the employee is in the 22% federal income tax bracket and unable to benefit from the SALT deduction, the employee pays $22 in federal taxes and $5 in state taxes, leaving $73 in after-tax income.

Under the payroll tax shift, an employer who pays an additional $95 to an employee would be subject to a $5 payroll tax. The total cost to the employer still would be $100, which would remain fully deductible for federal income tax purposes. The state personal income tax would remain in place, but the employee would qualify for a new 5% refundable wage credit, which would entirely offset the employee's state income tax liability with respect to the wages on which the employer has paid the payroll tax. The employee's gross income for federal tax purposes would be $95, not $100, because employer-side payroll taxes are not included in employee gross income. If the employee is in the 22% federal income tax bracket, the employee would pay $20.90 in federal taxes, leaving $74.10 in after-tax income ($1.10 more than before).

In this way, the payroll tax shift would raise after-tax income for employees without raising after-tax costs for employers. Note that in the example above, the employer pays the same amount under current law and under the proposal: $100 in wages (current law) or $95 in wages plus $5 in payroll tax for a total of $100 (proposal). In either case, the full $100 is deductible for federal income tax purposes. But importantly, the employee's after-tax income rises by $1.10, or about 1.5%. And moreover, this payroll tax shift yields benefits for employees regardless of whether they itemize deductions or claim the standard deduction on their federal income tax returns.

The payroll tax shift also would preserve the ability of state and local governments to fund public services with pre-federal-tax dollars. Aside from each state's parochial interest in minimizing its own residents' federal income tax liability, there are strong policy justifications in favor of deductibility for payments to state and local governments. The primary expenditure for state and local governments is education—i.e., investment in human capital. In a tax system that generally allows an immediate deduction for business investments in physical capital, there is little reason to deny deductibility for human capital investments as well. And in a tax system that allows a deduction for charitable contributions that go toward schools, hospitals, and social welfare programs, there is little reason to deny deductibility for dollars that flow to those same causes through civic institutions.

Questions, Answers

One question raised by the proposal for a payroll tax shift is whether the Internal Revenue Service would argue that an employee's taxable income should grossed up by the amount of the employer's payroll tax payment or the offsetting wage credit. Such an argument, though, would have little basis in practice or precedent. The IRS has never considered employer-side payroll taxes to be part of an employee's gross income, and the Supreme Court has said that a tax credit is not part of the recipient's taxable income in the absence of ''compelling evidence'' that Congress intended for the credit to be considered as such. Unless and until Congress changes the law, the employee in the example above would have gross income of $95 rather than $100 for federal tax purposes.

The Supreme Court's decision in the famous 1929 case of *Old Colony Trust v. Commissioner* is not to the contrary. In *Old Colony Trust*, the Court held that where an employer pays taxes on behalf of an employee, the employer's payment is included in the employee's gross income. But the central fact emphasized by the *Old Colony Trust* Court was that the taxes in question ''were imposed on the employee.'' Here, by contrast, the payroll tax would be the legal obligation of the employer. This is not a mere formality: if the employer fails to pay the state payroll tax, the employer—not the employee—would face the civil and potentially criminal consequences.

A second question is whether wages would adjust to reflect the shift from a personal income tax to a payroll tax. In the example above, the employer and employee each are no worse off in pre-federal-tax terms (and the employee is better off after federal taxes) if the employer pays $95 in wages and $5 in payroll taxes instead of $100 in wages subject to an employee-side income tax. But nominal wages are notoriously sticky, and employers and employees might fail to adjust wages downward in the amount of the new employer-side payroll tax. Without such an adjustment, the payroll tax shift could result in a rise in employers' costs.

Arguably, the rise in employers' costs is no problem at all when it is paired with an (even large) increase in employees' after-tax wages. But insofar as state lawmakers are concerned about employer objections, they can address this concern in two ways. First, they can phase in the payroll tax and the wage credit at the rate of inflation so that real costs to nonadjusting employers remain constant. Second, they can add an opt-out provision so that employers who did not want to subject themselves to the new regime would not have to. For example, a state could allow employers to pay a nominal fee in order to be exempt from the new payroll tax, with the consequence that the employees would not be eligible for the wage credit either. Over time, as employers come to discover that the payroll tax shift delivers significant after-tax benefits for their employees and so helps them attract talented workers, fewer and fewer employers would choose to opt out.

Finally, the example above involves a state with a flat income tax rate, not a state with a graduated rate structure. Currently, eight states have flat income tax rates: Colorado, Illinois, Indiana, Massachusetts, Michigan, North Carolina, Pennsylvania, and Utah. States with progressive income tax systems, such as California and New York, will face a choice as to what rate to set the

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new payroll tax and wage credit. For example, New York might choose to set the rate at around 4%, approximately equal to the effective state income tax rate for the median household. For wage-earners with above-median incomes, the corresponding wage credit would not offset their personal income tax liability fully, and so they would owe a (modest) additional amount. For wage-earners with below-median incomes, the wage credit would more than offset their personal income tax liability, and so they would receive an end-of-year state tax refund.

But Should They?

The analysis above illustrates that states and municipalities with personal income taxes *can* deliver significant savings to their residents by shifting toward a payroll tax system. But the fact that something is possible does not necessarily mean that it is normatively desirable. Perhaps the gravest worry is that a payroll tax shift would amount to robbing the federal Peter in order to pay the state Paul. The potential revenue losses for the federal government in the event that a number of states execute a payroll tax shift could rise into the hundreds of billions of dollars.

Yet the revenue losses to the federal government should not stop states and municipalities from acting. The new tax law reflects a misguided policy choice: Congress has decided to deliver massive tax benefits to multinational corporations and high-income households while also making it more difficult for state and local governments to raise revenue. It turns out, though, that the revenue that Congress thought it would generate by rolling back the SALT deduction may not materialize. By fighting to preserve their residents' ability to pay for public services with deductible dollars, states and municipalities can prod members of Congress to reconsider what was a foolish decision from the outset.

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