

NY Lawsuit Challenging Federal SALT Cap: The Complaint

By **Irwin Slomka** (August 20, 2018, 2:45 PM EDT)

New York state, together with the states of New Jersey, Connecticut and Maryland, has brought suit in federal district court seeking to invalidate on constitutional grounds the \$10,000 cap on state and local tax, or SALT, deductions enacted as part of the Federal Tax Cuts and Jobs Act of 2017.[1] This unusual action is the first direct attempt by states to invalidate the federal SALT deduction limitation. Based on the complaint and the very limited judicial precedent cited, the plaintiff states face considerable hurdles in pursuing this case.



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Background

Effective beginning in 2018, the federal legislation limits to \$10,000 for individuals and married couples filing jointly the annual federal itemized deduction for the aggregate of state and local income, property and sales taxes. The legislation substantially increased the standard deduction, in the case of married individuals filing jointly, from \$12,700 to \$24,000.

In April 2018, Gov. Andrew Cuomo sought and obtained state legislation as a partial workaround to the SALT limitation in the form of an optional New York state employer payroll tax, effective for tax years beginning after 2018, imposed on electing businesses. This tax would presumably be fully deductible by the employer for federal purposes, while covered employees are provided with a credit against their state personal income tax for equivalent amounts. The governor is also considering a 5 percent state unincorporated business tax on partnerships and limited liability companies to further mitigate the effects of the SALT limitation with respect to nonwage income. The U.S. Treasury Department has already issued a pronouncement cautioning that certain state workarounds to the federal SALT limitation will be scrutinized and indicates that it will issue proposed regulations to address the issue.[2]

States' Constitutional Challenge

The lawsuit was brought in the Southern District of New York by the New York state attorney general and was joined by the nearby states of New Jersey, Connecticut and Maryland, all of which are recognized as high income tax jurisdictions. The suit is a constitutional challenge to the SALT deduction limitation and seeks an injunction against its enforcement (although it is not clear what IRS enforcement needs to be enjoined at this time). Claiming that the new cap “effectively eviscerates” the SALT deduction and “overturn[s] more than 150 years of precedent,” the lawsuit seeks to invalidate the SALT deduction limitation on constitutional grounds.

The thrust of New York's and the other states' constitutional arguments is threefold:

- *Tenth Amendment and "Sovereign Authority"*: The states claim that the SALT deduction limitation interferes with the states' "sovereign authority" to determine their own tax and fiscal policies and is therefore prohibited under the Tenth Amendment of the U.S. Constitution ("The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people"). The complaint notes that state sovereign authority was an explicit concern of the founders who designed the U.S. Constitution. The fact that SALT deductions have been substantially permitted since the first federal income tax was enacted in 1861 is allegedly "strong evidence that the federal government lacks constitutional authority to drastically curtail the deduction."

Likely in recognition of the reality of taxpayers "voting with their feet," the complaint also asserts that the new limitation "will make it more difficult for the plaintiff states to maintain their taxation and fiscal policies." It cites no judicial precedent for the states' claim that the new cap "violates bedrock principles of federalism enshrined in the Tenth Amendment."

- *Legislative History of Enactment of the Sixteenth Amendment*: The SALT deduction limitation also allegedly violates the Sixteenth Amendment of the U.S. Constitution, which is the source of the federal income tax that went into effect in 1913 ("The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."). According to the Complaint, the SALT limitation violates the Sixteenth Amendment because, when ratified in 1913, "it was widely understood that, to the extent the federal government taxed income, it would provide a deduction for all or a significant portion of state and local taxes." The source for this claim is largely based on "assurances" provided by several U.S. senators leading up to ratification of the Sixteenth Amendment that the imposition of a federal income tax would not "encroach on the States' ... ability to impose their own state tax regimes free from federal interference." Prior limitations of the SALT deduction — such as the removal of the state and local sales tax deduction in 1986 and limiting the deduction for higher income taxpayers — are dismissed in the complaint as "incidental limitations."
- *"Coercion" Claim*. The lawsuit also alleges that various officials — "President Trump, Secretary Mnuchin and numerous Republican legislators" — "made clear [that] their intention was to injure the Plaintiff States and thereby coerce them into changing their tax policies." It goes so far as to claim that "the Plaintiff States were not only targeted for unequal treatment but were also deprived of a fair opportunity to participate in the law making process to protect their interests."

Referring to "the coercion here [as] unprecedented and unlawful," the complaint cites *United States v. Butler*[3], a 1936 U.S. Supreme Court decision striking down the imposition of a federal tax on cotton, finding that the power to regulate agriculture was reserved to the states under the Constitution. That case has rarely been cited by the Supreme Court in recent years.

In sum, the plaintiff states' lawsuit is largely based on the claims of federalism rooted in the Constitution. Its underpinning is the legal claim that the SALT deduction itself is constitutionally protected. However, it is also clear that the complaint is by and large a political document and an action that faces a difficult road ahead in the courts. Although some have predicted that other states will join the lawsuit, to date no other states have done so. An answer to the states' complaint is due Sept. 18, 2018.

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[1] New York v. Mnuchin, Civil Action No. 1:18-cv-6427 (S.D.N.Y., filed July 17, 2018).

[2] I.R.S. Notice 2018-54, 2018-24 I.R.B. 750.

[3] United States v. Butler, 297 U.S. 1 (1936).