POLITICS

Treasury Readies Its Punch Back at Blue States' Workarounds on Tax Deduction Cap

Rules are expected to block strategies used in New York, New Jersey and Connecticut, but similar credits in Alabama, Arizona, Georgia and South Carolina predate GOP tax law

States with pre-existing tax credits for certain charitable donations have urged Treasury Secretary Steven Mnuchin to protect the programs. PHOTO: JOSHUA ROBERTS/BLOOMBERG NEWS

By Richard Rubin

Aug. 22, 2018 8:00 a.m. ET

WASHINGTON—The Trump administration is finishing what's expected to be a crackdown on state laws circumventing the new $10,000 federal cap on individual deductions for state and local taxes.

The rules are likely to halt a strategy embraced in New York, New Jersey and Connecticut, high-tax states where high-income residents are getting pinched by the cap. Tax experts are watching the rules for how Treasury handles similar credits that predate last year's GOP tax law, including programs in Alabama, Arizona, Georgia and South Carolina.

Though New York, New Jersey and Connecticut have different approaches, all let taxpayers claim a partial credit against state or local taxes if they make donations to government-backed charities. Taxpayers, on their federal returns, would claim those donations as deductible charitable contributions—which don't face the new cap.

Treasury officials have warned for months that they would block these workarounds and the Office of Management and Budget recently finished its review of the regulations, signaling their release is imminent.

"The expectation I have is that the IRS would disallow the recharacterization of a tax payment as something else, as a charitable contribution," said Jared Walczak, a senior policy analyst at the conservative-leaning Tax Foundation.

The biggest open question is what happens to similar tax breaks in other states.

For instance, Arizona, Alabama, Georgia and South Carolina let taxpayers get a 100% state tax credit for donations to charities supporting private schools. That is more generous than the New York, New Jersey and Connecticut proposals and those programs have important political backing from Republicans and the conservative school-choice movement.

Before the new tax law, those programs generally didn't provide a federal tax advantage, because taxpayers turned deductible state taxes into deductible charitable contributions. They directed how their state taxes were spent but often didn't pay less in total tax.

But now those programs are pitched by accountants as savvy tax-avoidance moves to turn nondeductible state taxes into deductible charitable contributions. A top-bracket taxpayer making a $10,000 contribution can save $10,000 on his state taxes plus $3,700 on his federal taxes.

The IRS could draw a distinction between donations to publicly controlled entities and private organizations, disallowing the former and permitting the latter. It could also limit benefits so taxpayers can make contributions but can't turn a profit.

"They would still be very generous credits that reduce your state tax liability," Mr. Walczak said. "But you may not be able to double up."

Lawmakers from states with pre-existing credits have urged Treasury Secretary Steven Mnuchin and his staff to protect the programs.

"They are sympathetic, but they haven't made a commitment yet," said Sen. Johnny Isakson (R., Ga.) "We're going to get as much as we can."

Democrats will object to the regulations, because they represent the high-tax states where the cap will have the largest effects on taxpayers. But without control of Congress or the Treasury Department, their options are likely limited to state lawsuits or challenges by taxpayers willing to fight an audit.

"No regulations will prevent middle-class families from getting clobbered with a massive tax bill," said Sen. Ron Wyden (D., Ore.) "Republicans used the state and local deduction as a tool to shower corporations with permanent tax cuts."

Write to Richard Rubin at richard.rubin@wsj.com