

The State and Local Tax Deduction Is in Peril - The Cavalry Does Not Appear to Be on Its Way to Rescue It

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Background

Prior to the Tax Cuts and Jobs Act ("TCJA"), there was no direct limitation on an individual taxpayer's deduction of his or her state and local taxes ("SALT") on the federal individual income tax return. Of course, for high-income taxpayers, the SALT deduction often triggered the alternative minimum tax.

As of 2018, as a result of the TCJA, the SALT deduction for individuals was capped at \$10,000 per year for both single and married taxpayers filing jointly (\$5,000 for married taxpayers filing separately). Hence, the cap contains an inherent "marriage penalty."

The SALT cap was added to the TCJA, in part, as a compromise for an increase in the standard deduction (almost doubling it from pre-TCJA days). It is, however, set to sunset at the end of this year.

The impact of the SALT cap is dramatic. Following the enactment of the TCJA, individual federal income tax returns claiming a SALT deduction decreased from 37% (2017) to roughly 9% (2022).

The Joint Committee on Taxation ("JCT") projects that, if the SALT cap is allowed to expire, the limited deduction, which is currently estimated to cost the federal government \$23 billion for 2025, will increase to a cost of \$197 billion for 2027 as a much broader population of taxpayers will be eligible for the deduction (which in essence will not be directly limited).

Proponents of the current SALT cap pronounce that the deduction, unless capped, puts too much of the burden of state and local taxes on the federal government. By reducing the deduction's value, the SALT cap in essence shifts much of the burden of state and local taxes to the taxpayers rather than the federal government.

In high-tax states such as Oregon, California, Hawaii and New York, the impact of the SALT cap has been significant, especially on high-income taxpayers. It does not appear that lawmakers are going to allow the SALT cap to sunset at the end of this year. Further, no one has summoned the cavalry to offer aid to the

impacted taxpayers.

House Proposal

Lawmakers have had heated exchanges over the SALT cap in recent days. The current proposal pending in the U.S. House of Representatives ("House"), which has Republican representatives from high-tax states unhappy, offers limited relief. The proposed bill increases the SALT cap from \$10,000 to \$30,000, but it contains a downward adjustment for taxpayers with "modified adjusted gross income" over \$400,000. For this purpose, modified adjusted gross income is adjusted gross income plus any amounts excluded from income under Code Sections 911, 931 and 933. Under the proposal, the \$30,000 cap is reduced by 20% of a taxpayer's modified adjusted gross income to the extent it exceeds \$400,000 (\$200,000 in the case of a married taxpayer filing separately). However, the SALT cap cannot be reduced below \$10,000 (\$5,000 in the case of a married taxpayer filing separately).

Note: the marriage penalty persists in the proposed legislation.

If my math is correct, under the House proposal, taxpayers who are single or married filing jointly get some relief from the SALT cap if their modified adjusted gross income is below \$500,000. At the \$500,000 and above level, the taxpayer reverts to a maximum SALT deduction of \$10,000.

EXAMPLE 1: Sally and Harry are married and file jointly, and their modified adjusted gross income in 2026 is \$500,000. They paid \$59,000 in state and local income taxes and \$10,000 in local property taxes. Under the House proposal, their SALT deduction is capped at \$10,000 [$\$500,000 - \$400,000 = \$100,000 \times 20\% = \$20,000$. $\$30,000 - \$20,000 = \$10,000$]. They get no benefit of the increased SALT cap.

EXAMPLE 2: Sally and Harry are married and file jointly, and their modified adjusted gross income in 2026 is \$400,000. They paid \$44,000 in state and local income taxes and \$10,000 in local property taxes. Under the House proposal, their SALT deduction is capped at \$30,000. There is no reduction in the SALT cap. So, they benefit from the increased SALT cap.

EXAMPLE 3: Sally and Harry are married and file jointly, and their modified adjusted gross income in 2026 is \$450,000. They paid \$49,000 in state and local income taxes and \$10,000 in local property taxes. Under the House proposal, their SALT deduction is capped at \$20,000 [$\$450,000 - \$400,000 = \$50,000 \times 20\% = \$10,000$. $\$30,000 - \$10,000 = \$20,000$]. There is a \$10,000 downward adjustment in the SALT cap. So, they partially benefit from the increased SALT cap.

Representative Tom Suozzi (D-New York) recently offered a SALT cap proposal that increases the cap to \$80,000 (\$40,000 in the case of a married taxpayer filing separately). That proposal was rejected.

A handful of lawmakers have indicated that a SALT fix is pivotal to their support of any tax package being considered by lawmakers. In fact, Representative Mike Lawler (R-New York) has stated that he will not stand behind any bill that does not adequately lift the SALT cap. Additionally, at least one member of the House has stated something along the lines of: "No SALT Fix, No Deal!"

Conclusion

Time will tell what lawmakers will do with the current SALT cap. It seems certain that they will not allow it to sunset. Whether the limited relief discussed above will become law or whether a more favorable cap will find its way into law, however, is yet to be seen. Taxpayers from high-tax states and their tax advisers need to keep a close eye on this issue.

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