

HOW VOUCHER ADVOCATES CREATED A BLUE-STATE LOOPHOLE TO TRUMP'S TAX LAW



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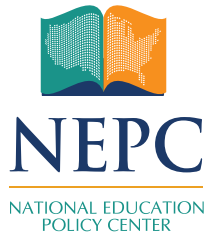
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Policymakers in California, New York, New Jersey and other “Blue” states are looking for a work-around to a particularly partisan element of the law that President Trump signed in December. The provision [caps](#) the federal deduction for the payment of state and local taxes (called “SALT”) at \$10,000. Individuals with more than \$10,000 in SALT payments lose the deduction on those excess amounts. Republicans in Congress embraced this change as a two-fer: they could place a disproportionate tax burden on states that voted for Hilary Clinton (the 10 states hardest hit by the provision are [all Hillary states](#)), and they can put pressure on these states to lower state and local taxes and corresponding public services.

The leaders of these higher-tax states, however, have come up with a sneaky but sensible response to the new federal tax law’s targeting of those states and their taxpayers with additional tax liability. And it’s the derivation—the history—of this tricky idea that’s particularly fascinating and that puts Republicans in a difficult bind.

To understand the issue, consider California, where over a quarter of the state’s taxpayers will likely exceed the \$10,000 cap, making [about \\$100 billion](#) of Californians’ income subject to the new taxes. Assuming the new 37% marginal tax rate is applied to this income, the federal government will collect \$37 billion more from Californians than it would have without the new cap.

But a bill already introduced, [SB 227](#) (dubbed the “Protect California Taxpayers Act”), is aiming for a loophole that would protect the state’s taxpayers. While SALT deductions have these new limits, charitable contributions do not. Moreover, California and other states have long had so-called [public-purpose funds](#) with the status of charities, accepting taxpayers’ donations that [can then be deducted](#) from federal taxes. SB 227 would add a dollar-for-dollar tax credit for donations to these public-purpose funds. The donated money would then be transferred to California’s coffers for use as before.

Californians owing SALT payments exceeding the \$10,000 cap can donate that excess amount to the state, get the 100% tax credit, and completely avoid the harms of the new federal

tax law.

Where did this devious idea of California Democrats come from? Republicans, actually. Specifically, Republicans seeking ways to avoid legal restrictions on creating vouchers to fund private religious schools. In fact, these same voucher advocates have cleared the legal path for SB 227.

To get around their state constitution's ban on spending public money on religious schools, [Arizona Republicans](#) in 1997 created a dollar-for-dollar tax credit. For instance, a taxpayer who owed \$500 in taxes could instead send that money to a "School Tuition Organization" set up specifically to receive these donations. It would package that \$500 with similar donations and distribute them as vouchers to pay for private school tuition.

Voucher advocates successfully defended this scheme against [legal challenges](#), arguing that the state constitution doesn't prohibit tax credits, only direct allocations. The dollars that ended up with the religious schools never made their way into the state coffers. All the state did was issue a tax credit. The [Arizona Supreme Court split 3-2](#), but the majority accepted this argument. The flabbergasted [dissent](#) called this a "dangerous doctrine that permits the state to divert money otherwise due the state treasury and apply it to uses forbidden by the state's constitution." It argued that the scheme "is not an inducement to charitable giving; there is no philanthropy at all because the credit provided is dollar-for-dollar."

Importantly for SB 227 and similar policies under consideration in other states, the majority of the Arizona court and others accepted the argument that these taxpayer donations are legitimate charitable giving, [even though](#) the 100% tax credit makes the donations cost-free. The SB 227 approach finds support in [other types of tax credits](#) as well.

Eighteen states have now adopted these tax-credit-dependent voucher (or "[neovoucher](#)") systems, about which the bill's Arizona sponsors [boasted](#), "This has turned into something so close to vouchers you almost can't tell the difference" and "Why do we need vouchers at this point?"

These neovouchers are clever work-arounds, avoiding a legal prohibition with the help of tax credits. So far, it has worked. Even the U.S. Supreme Court, in a 2010 case called [Arizona Christian School Tuition v. Winn](#), bought into the distinction, in a decision that disallowed taxpayers from even challenging the constitutionality of the Arizona law in federal court. The Court's majority reasoned that while the plaintiffs would have legal standing to challenge a direct voucher appropriation, they lack standing to challenge a tax credit because it "does not extract and spend [their] funds." That is, a tax credit might accomplish the same thing, but it can be treated as legally different.

In fact, the overlap between the tax issues raised by neovoucher policies and by SB 227 is even more glaring. As the Institution on Taxation and Economic Policy [has explained](#), some wealthier taxpayers are subject to the Alternative Minimum Tax (AMT), and AMT rules disallow a deduction for SALT payments but allow a deduction for charitable donations. That is, the new federal tax law's deductibility rules mirror the old AMT rules.

Not surprisingly, taxpayers subject to the AMT who owed taxes in states with neovoucher

laws used those laws in precisely the way that SB 227's backers are now proposing. They used the neovoucher policies to convert SALT into charity—to transform their taxes owed to the state into a charitable contribution. In fact, in such neovoucher states, the [new federal tax law will make these transformations attractive](#) to taxpayers who, even if not subject to the AMT, would otherwise be making SALT payments in excess of \$10,000.

And that's the rub. Approaches like that embodied in California's SB 227 would do what the neovoucher laws in these 18 states already do: allow taxpayers owing more than \$10,000 in SALT payments to make donations that convert those payments into charitable contributions. The difference is that SB 227 contributions will help fund public schools (and other public services) while neovoucher contributions help fund private schools.

So Republicans are in a bind. They want to preserve their tax credit gambit to use public funds to subsidize religious schools, but they also want to prevent Blue states from sidestepping the new tax law. One option is for Congress to close the SB 227 loophole with a new law. Another is to hope that the IRS draws a crafty distinction that allows one but not the other. If it does, legislators in California and other high-tax states can take [additional steps](#) to make their approach more bulletproof.

First, make the tax credit for donations to the California public-purpose fund only 95 percent, not a dollar-for-dollar credit, thus becoming a more “normal” tax credit. Of the approximately \$37 billion not sent to the federal government, \$5 billion would go to California, while \$32 billion would remain with its taxpayers. This approach also has the advantage of the irony that the federal tax law would be facilitating increased revenue generation in these Blue states.

Second, increase the options for the public-purpose funds, giving taxpayers additional choices among state services they want to fund. Current niche options, like the [Special Olympics and Diabetes Research](#), can be broadened to include major budget lines like higher education, K-12 education, health care, transportation, prisons, and pensions might each have their own fund. Each could be capped, to ensure that too much is not directed to a given fund.

The point here is that even if the specific proposal in SB 227 isn't a doppelganger to neovoucher laws, it could be given sufficient plastic surgery to eventually become indistinguishable. If the above two suggestions don't do the trick, then state and local governments can pull out even more line items from their budgets. What's to stop cities from partially funding their fire departments with public-purpose-fund donations? If the IRS reverses its rule regarding public-purpose funds, what's to stop state and local governments from providing some services through private non-profits that are even more akin to school-tuition organizations?

When Donald Trump [said](#) during the first presidential debate that avoiding federal taxes demonstrated how smart he was, he was illustrating the job of clever lawyers and accountants. Wealthy people like Mr. Trump hire these professionals to (among other things) creatively move money around in ways that minimize taxes. The level of subterfuge with tax avoidance can be byzantine and shocking, but it can be perfectly legal.

So, yes, this is all lawyerly hocus-pocus, and Republicans might reasonably argue that Blue states shouldn't be allowed to create a loophole that magically transforms a tax payment into a charitable contribution. But that argument is laughable if they simultaneously argue that a loophole is splendid when tax credits are used to launder unconstitutional state support for religious schools. If Republicans object to states circumventing their tax law, they have no one but themselves to blame.