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IRS SALT Cap Workaround Rule Unlawful, 2nd Circ. Told

By **Maria Koklanaris**

Law360 (March 20, 2025, 6:33 PM EDT) -- The Internal Revenue Service unlawfully created a rule prohibiting workarounds to the federal cap on state and local tax deductions, a New Jersey deputy attorney general told a Second Circuit panel Thursday, asking the appellate judges to overturn a lower court ruling that upheld the rule.



The Second Circuit held oral arguments over challenges by state attorneys general to an IRS rule preventing workarounds to the federal cap on state and local tax deductions. (iStock.com/Natalia Bratslavsky)

The panel heard oral arguments Thursday after attorneys general from New York, New Jersey and Connecticut **asked the Second Circuit** to revive their challenge to the IRS rule. Along with the states, the village of Scarsdale, New York, is also suing to have the rule overturned.

The 2019 federal regulation barring the use of some state programs that give taxpayers a credit against state income taxes for charitable donations to public funds runs contrary to Internal Revenue Code **Section 170**, which governs deductions for charitable donations, Christopher J. Ioannou of the New Jersey attorney general's office said.

"Despite 100 years of text precedent and practice, the IRS has for the first time singled out state tax credits for disfavor under Section 170," Ioannou said. "That is unlawful, arbitrary and capricious."

The IRS made an "about-face" with its rule barring the state tax credit program, Ioannou said.

"Previously, the IRS itself recognized that there is no reason to distinguish between the value of a state or federal tax deduction or to draw a bright line based on the amount of the tax benefit in question," he said.

Arguing for Scarsdale, Daniel Rosen of Baker McKenzie told the panel that in addition to reversing itself, the IRS exceeded its authority. The agency and the U.S. Department of the Treasury overreached when deciding that the state tax credit programs but not certain deductions are disallowed under a doctrine of quid pro quo: If an individual is making a true charitable contribution, the agencies said, the individual should have no expectation of getting something in return.

"This is beyond the scope of their authority to draw those distinctions," Rosen said. "There's no way you can conclude that the single-best reading of Section 170 would allow for the treatment of a credit as a quid pro quo, but not a deduction."

But arguing for the federal government, Rebecca Sol Tinio, an assistant U.S. attorney, told the appellate panel that the law since the end of 2017 reflects a state and local tax deduction that is capped at \$10,000 and that the creation of the state tax credits was aimed at circumventing that law.

"The plaintiffs created their funds to give their residents a means to recreate an uncapped federal SALT deduction by rebranding it as a Section 170 charitable contribution deduction," Tinio said.

She said the IRS has authority to act when it perceives that a workaround to a law has been created.

"It is certainly a great American tradition that when workarounds are created, the IRS looks at them and decides if it wants to respond in order to implement a number of legitimate purposes," Tinio said. "One of which is implementing and maintaining the purpose of the SALT cap itself."

The oral arguments occurred Thursday after the Second Circuit agreed to revive the states' challenge to the rule barring the state tax credit program. The states maintained that a lower court judge improperly deferred to the IRS' interpretation of the statute in **upholding the rule** in March 2024, according to a brief they filed with the Second Circuit.

U.S. District Judge Paul G. Gardephe relied on the Chevron standard in granting deference to the agency's interpretation of Section 170, but that standard was overturned by the U.S. Supreme Court in June in its decision in **Loper Bright Enterprises v. Raimondo**, the attorneys general noted. Under Loper Bright, courts must instead ask whether an agency's interpretation is the best reading of a statute, the brief said.

The states are appealing Judge Gardephe's decision, which rejected their arguments that the final regulations clashed with Section 170 and overstepped the IRS' authority. The states also asked the Second Circuit to find that New York, New Jersey and Connecticut all have standing to challenge the rule. Judge Gardephe found that only New York had such standing, but all three states will be harmed if the rule is upheld because they will lose out on substantial donations to state coffers, the brief said.

The final regulations barred some programs in which taxpayers receive a credit against their state income taxes for donations made to charitable funds set up by the state in an attempt to reduce the impact of the federal cap on state and local tax deductions. The **Tax Cuts and Jobs Act**, the 2017 tax overhaul law, enacted a \$10,000 cap on state and local deductions.

One month after the regulations were issued, in July 2019, New York, New Jersey and Connecticut sued the IRS and the Treasury, former Internal Revenue Commissioner Chuck Rettig and former Treasury Secretary Steven Mnuchin, asking the court to strike down the rules.

Senior U.S. Circuit Judge Robert D. Sack and U.S. Circuit Judges Myrna Perez and Beth Robinson sat on the panel Thursday.

The states are represented by Christopher J. Ioannou and Jeremy Feigenbaum of the New Jersey Office of the Attorney General, by Ester Murdukhayeva of the Office of the New York State Attorney General and by Joshua Perry and Michael Skold of the Office of the Connecticut Attorney General.

The village of Scarsdale is represented by Daniel Rosen of Baker McKenzie, by Andrew Weiner of Kostelanetz LLP and by Michael Todd Welty of Todd Welty PC.

The government is represented by Benjamin H. Torrance, Rebecca S. Tinio and Jean-David Barnea of the U.S. Attorney's Office for the Southern District of New York.

The cases are New Jersey et al. v. Yellen, case number 24-1499, and Village of Scarsdale, New York v. Yellen, case number 24-1503, in the U.S. Court of Appeals for the Second Circuit.

--Editing by Emma Brauer.

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