Office of the General Counsel

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SALT Cap Charitable Deduction Workaround Final Regulations

Issue Bulletin

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Re: SALT Cap Workaround – IRS Final Regulations

On June 11, 2019, the Internal Revenue Service ("IRS") released final regulations addressing the State and Local Tax ("SALT") cap workarounds enacted by states in response to the Tax Cuts and Jobs Act of 2017 (Pub. L. 115-97). The regulations finalize the donative intent and quid pro quo approach contained in the proposed regs, which requires that individuals making payments to charitable organizations and receiving a state tax credit in return must reduce their federal charitable contribution deduction by the amount of the state or local tax credit received. The regulations apply to new and preexisting state tax credit programs, including long-standing scholarship granting programs.

This Issue Bulletin will provide an overview of the law and its impact on various categories of donors nationwide.

Overview of Applicable Code Sections and State Workarounds

Internal Revenue Code section 170(a)(1) generally allows an itemized deduction for any charitable contribution paid within the taxable year. Section 170(c) defines "charitable contribution" as a "contribution or gift to or for the use of" any entity described in that section.

Under section 170(c)(1), such an entity includes a State, a possession of the United States, or any political subdivision of the foregoing, or the District of Columbia. Entities described in section 170(c)(2) include certain corporations, trusts, or community chests, funds, or foundations, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes.

Section 164 generally allows an itemized deduction for the payment of certain taxes, including state and local real and personal property tax and excess profits taxes. Section 164(b)(6), which was added by the Tax Cuts and Jobs Act of 2017, limits an individual's deduction for the aggregate amount of state and local taxes paid during the calendar year to $10,000.

In response, several high-tax states (i.e., New York, New Jersey, California) instituted workarounds to help taxpayers circumvent the $10,000 cap on federal deductions for SALT payments. These state workarounds included provisions allowing taxpayers to donate to charity funds and, in exchange, receive tax credits against their state and local taxes. Taxpayers could then deduct their donations as charitable contributions on federal taxes, lessening their broader tax burden.

Overview of the Final Regulations and Notice 2019-12

Final Regulations

The final regulations block SALT workarounds and limit the value of state credits. The final rules require individual taxpayers making payments to a charitable organization in exchange for a state or local tax credit to reduce their federal charitable contribution deduction by the amount of that credit.

Example: An individual taxpayer donates $1,000 to a state program and receives a 70% state and local tax credit. Rather than claim the entire $1,000 as a charitable contribution deduction on his or her federal tax return, the individual taxpayer must reduce the $1,000 donation by the amount of the state tax credit received. Thus, the taxpayer can only claim $300 as a charitable contribution deduction.

The final regulations provide one exception: state tax credits that do not exceed 15% of a donation are exempt from the final regulations. Thus, a taxpayer who makes a $1,000 contribution is not required to reduce their charitable contribution deduction on their federal tax return if the state or local tax credit they received is $150 or less.

The IRS rejected the suggestion from many commenters that a "substance over form" approach

be used in the final regulations rather than a quid pro quo approach. Under a substance over form approach, commenters argued the regulations could treat contributions to funds established by state or local government entities in exchange for tax credits as, in substance, a payment of taxes to those government entities. These commenters stated that by relying on the substance over form doctrine, the regulations could have been more easily tailored to address only those contributions paid to funds established to assist taxpayers in avoiding the limitation on state and local tax deductions.

In the final regulations, the IRS provides it determined that the quid pro quo principle "provides a more sound, comprehensive, and administrable approach." Further, the IRS argued that this approach would result in an expansion of the definition of "tax" under section 164, would raise questions involving the timing of deductions for such payments, and would result in different treatments for similarly situated taxpayers.

Notice 2019-12

The IRS also issued Notice 2019-12 proposing a safe harbor for taxpayers who itemize deductions and are under the $10,000 SALT cap limit. Under the quid pro quo requirements in the final regulations, the taxpayer would be ineligible to take a federal charitable contribution deduction for payments they made to charitable organizations for which they receive a state tax credit. Under the safe harbor, for federal deduction purposes, such individuals could elect to treat the portion of their payment to the charitable organization that would be disallowed under the final rules as a payment of state tax, up to the $10,000 SALT deduction limit.

How are donors impacted?

First, it should be noted that the final regulations only apply to donations made to charitable organizations for which the donor receives a state tax credit. There are approximately 100 different types of state credits that operate in this way. Donors who make contributions to charitable organizations and receive a state tax credit fall into one of three categories:

(1) Donors with SALT below the $10,000 cap;

(2) Donors over the $10,000 cap; or

(3) Corporate donors.

Donors with SALT below $10,000 cap

Notice 2019-12, which the IRS issued simultaneously with the final regulations, provides a safe harbor for individuals who itemize deductions and are under the $10,000 cap, but are precluded from taking federal charitable contributions deductions for payments they make to charitable organizations for which they receive a state credit. Under the safe harbor, for federal deduction

purposes, such individuals can elect to treat the portion of their payment to the charitable organization that would be disallowed under the final regulations as a payment of state tax up to the $10,000 SALT deduction limit.

Example: An individual taxpayer pays $5,000 in state tax. The taxpayer also donates $1,000 to a state program and receives a 70% state and local tax credit. Because the individual has not reached the $10,000 cap in state tax, the taxpayer may include the entire donation amount of $1,000 to the state program as a payment of state tax even though the taxpayer received a state credit in return. Thus, the taxpayer will be permitted to deduct a total of $6,000 from his or her federal return under section 164 for state tax paid.

Donors who have met the SALT cap (paid $10,000 or more in state tax)

The donors hit hardest by the final regulations are those who pay more than $10,000 or more in state tax. Neither the final regulations nor Notice 2019-12 provide relief for such taxpayers. The Urban-Brookings Tax Policy Center suggested that in 2018, 96% of the additional tax from the limitation of the SALT deduction would be borne by the top 20% of taxpayers and 50% by the top one percent.

Eighteen states provide tax credits for taxpayers who contribute money to private, religious, or public K-12 school scholarship funds, which range from 50% to 100% of the amount contributed.[1] These programs allowed high-income taxpayers who claimed both a large state tax credit and the federal tax deduction for charitable contributions to receive tax benefits; however, such taxpayers must now reduce their charitable contribution deduction by the amount of state tax credit received, which will likely result in a decrease of donations.

Corporate Donors

In December 2018, the IRS issued Revenue Procedure 2019-12, which provides a safe harbor under section 162 for certain payments made by a C corporation or a "specified pass-through entity" to or for the use of an organization described in section 170(c) if the C corporation or specified pass-through entity receives a state or local tax credit in return for such payment. Section 162 provides that a business entity may deduct certain payments that are ordinary and necessary business expenses if the payment was made for a business purpose. Accordingly, entities that meet the section 162 requirements may claim a deduction under section 162 for payments made to a section 170(c) organization for which the entity receives a state tax credit.

[1] Institute on Taxation and Economic Policy, "Does Your State Offer Tax Credits for Private K-12 School Voucher Donations," (June 10, 2019), *available at* https://itep.org/does-your-state-offer-tax-credits-for-private-k-12-school-voucher-donations/.

The final regulations retained the rules set forth in Revenue Procedure 2019-12. The safe harbor for C corporations provides that if a C corporation makes a payment to a section 170(c) organization and receives a tax credit that reduces a state or local tax imposed on the C corporation in return for such payment, the C corporation may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of section 162(a) to the extent of the credit received.

The safe harbor for passthrough entities (i.e., partnerships, LLC's, etc.) is identical to that for C corporations except passthroughs that receive a state tax credit that reduces its state and local tax *other than a state or local income tax*, may treat such payment as an ordinary and necessary business expense.

Example: The Commonwealth of Pennsylvania generally provides that a passthrough entity that contributes to a Pennsylvania SGO may take a state tax credit against its state income tax. Pursuant to the final regulations, the entity may *not* deduct this contribution as an ordinary and necessary business expense under section 162 because the credit reduced state income tax.

Conclusion

The general public's reaction to the final regulations has generally been negative, as it blocks the SALT workarounds, limits the value of state credits, and will likely cause taxpayers not to make donations to charitable nonprofits in communities throughout the country. New York, Connecticut, Maryland, and New Jersey have already brought a lawsuit against the IRS and Treasury seeking a declaration that the $10,000 cap of the SALT deduction is unconstitutional, and the House Ways and Means Committee will hold a hearing in late June to discuss "the impact of the SALT deduction cap on communities and possible next steps."

The regulations are effective on August 12, 2019, and apply to contributions made *after* August 28, 2018.