Treasury Releases Guidance on Permissibility of State Legislation to Circumvent SALT Deduction Cap

On Aug. 23, 2018, the Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) issued proposed regulations under Section 170 of the Internal Revenue Code (Code) addressing the federal income tax treatment and characterization of state legislation allowing certain charitable contribution payments made by taxpayers in exchange for a corresponding credit against state and local taxes (SALT).

Background

Section 164(b)(6) was amended by the *Tax Cuts and Jobs Act* (P.L. 115-97) to limit the deduction for the aggregate amount of state and local taxes paid during the calendar year to $10,000 for individuals and $5,000 for married individuals filing separately. Corporations and owners of passthrough entities may still fully deduct their business-related SALT liability. Prior to the passage of the TCJA, deduction for state and local taxes was unlimited for individuals who itemized their deductions. The new cap applies for tax years beginning after Jan. 1, 2018, and sunsets for tax years after Dec. 31, 2025.

Recently Passed State Legislation

As one of the TCJA's more politically controversial provisions, the limitation on the deductibility of state and local taxes ("SALT cap") has been criticized for disproportionately impacting taxpayers in high-tax states. Several state legislatures, including Connecticut, New York and New Jersey, have passed laws allowing taxpayers to circumvent the cap by making alternative payments in lieu of state and local taxes in exchange for a credit that can be used to offset state tax liability.

While various approaches to bypass the SALT cap have been proposed, most legislation is structured in one of the following ways:

1. **Charitable Contribution for Credit Model (New York, Connecticut and New Jersey):** The charitable contribution approach allows localities to provide a property tax credit to individuals donating to select community organizations. The credit is generally equal to the lesser of the amount of property tax owed or a certain percentage of the donation to the community organization. The intent of these programs is to provide taxpayers with not only a state credit for their donation, but also a federal tax deduction for the charitable contribution.

   States have defined community organizations differently. Some specify that the funds must be set up by municipalities or school districts to finance public projects, while others are purposefully vague and do not specify the types of organizations that qualify for the deduction.

   The charitable contribution approach predates the TCJA. Starting in 1986, Congress disallowed the SALT deduction for taxpayers subject to the federal alternative minimum tax (AMT), while preserving the charitable contribution deduction. As a result, states enacted tax credit programs that followed a similar structure to the current proposals: taxpayers who made charitable donations to approved organizations or funds would receive a state income tax credit to offset the cost of the donation. The amount of the state credit was generally a set percentage of the donation amount. For example, if a taxpayer made a $100 donation in a state providing a 70 percent credit, the taxpayer would receive a state income tax credit of $70.

About 33 states had charitable contribution for credit programs prior to the enactment of the TCJA. The IRS had not published official guidance addressing the question of whether a state or local tax credit was a *quid pro quo* benefit that would affect the amount of a taxpayer's deduction under section 170(a). However, this issue had been discussed in several Chief Counsel Advice memoranda, which are not precedential. In these memoranda, the IRS took the position that the amount of the taxpayer's charitable contribution deduction is not reduced by the amount of the state tax credit.

2. **Passthrough Model (Connecticut):** Under this approach, states create a new entity-level state tax on a passthrough's taxable income (e.g., 6.99 percent tax in Connecticut). Since state and local taxes paid by businesses are still deductible at the federal level, members and owners of participating passthroughs may lower their federal tax liability by claiming the new tax as a business deduction. Individual members of the passthrough entity subsequently receive a corresponding refundable individual income tax credit to offset the taxes paid at the entity level. This approach is based on the fact that passthrough income is taxed at the individual level and not taxed at the entity level. By imposing a tax at the entity level, the proposal shifts the tax liability from a non-deductible source to a deductible source.

   The proposed regulations do not address the passthrough model.

3. **Payroll Tax Model (New York):** States that employ this approach have designed a voluntary employer payroll tax program that allows participating employers to assume an employee's state tax liability (e.g., New York's employer compensation expense program, or ECEP). Participating employers would pay a set percentage payroll tax on wages in excess of a threshold amount per employee. The employee would then receive a tax credit equal to the payroll tax paid by the employer, which could be used to reduce the employee's own SALT liability. The employer would subsequently deduct that voluntary payroll tax expense from its own tax bill since the TCJA does not prevent corporations from taking such deductions.

   The proposed regulations do not address the payroll tax model.

Prior Guidance on SALT Cap

On May 23, 2018, in response to states enacting legislation to bypass the TCJA's SALT cap, the IRS issued Notice 2018-54, stating its intent to propose regulations addressing the federal income tax treatment of legislation that gives taxpayers a state tax credit against their state and local taxes.

The guidance issued today follows Notice 2018-54 and is intended to help taxpayers understand the proper characterization of payments in lieu of state and local taxes in exchange for credits for federal income tax purposes.

Overview of the Proposed Rules

The proposed regulations provide clarification on the relationship between the federal charitable contribution deduction, the availability of corresponding state or local tax credits and deductions, and the recently enacted SALT cap. Although some states had charitable contribution for credit programs prior to the amendment of Sec. 164(b)(6), the regulations note that the enactment of TCJA's SALT cap changes the analysis of what constitutes donative intent and whether payments to charitable organizations in exchange for a reduction in state tax liability are considered the receipt of a *quid pro quo*, which would ultimately negate donative intent. The regulations further state that the passage of the TCJA also requires the IRS and Treasury to consider congressional intent in amending Section 164(b)(6) and introducing the SALT cap. As discussed in the proposed regulations, sanctioning both pre- and post-TCJA charitable-contribution-for-credit legislation would result in revenue losses that would undermine the intent behind implementing the SALT cap. Additionally, as discussed in the examples of the proposed regulations, the IRS and Treasury state that they believe that both pre- and post-TCJA contribution-for-credit programs resulted in economic distortions. Accordingly, the proposed regulations seek to disincentivize taxpayers from making charitable contributions based on potential tax benefits and therefore make the federal tax system more neutral to taxpayers' decisions regarding donations.

The proposed regulations address the following issues:

1. **Treatment of Payments in Exchange for Deductions vs. Credits.** The proposed regulations discuss the proper federal income tax treatment of payments to charitable organizations under Section 170(c) in exchange for:
    a. A corresponding state or local tax credit; or
    b. A state or local tax deduction.

    The IRS and Treasury state that if a taxpayer makes a payment or transfers property to an organization eligible to receive tax-deductible contributions, and the taxpayer receives or expects to receive a state or local tax credit in return for the payment, then the tax credit constitutes a *quid pro quo*. As a result, the amount otherwise deductible as a charitable contribution must be reduced by the value of the state or local tax credit received or expected to be received. Therefore, taxpayers who make payments to organizations eligible to receive tax-deductible contributions must reduce their charitable deduction by the amount of any state or local tax credit received, just as they would with any other benefit. However, the regulations do provide a *de minimis* exception (see below).

    The proposed regulations draw a distinction between state or local tax credits and state or local deductions claimed in connection with a taxpayer's charitable contribution or transfer. Specifically, the proposed regulations allow taxpayers to disregard dollar-for-dollar state or local tax deductions received in exchange for payments or property transfers to a charitable organization. However, if the taxpayer receives a state or local tax deduction that exceeds the amount of the taxpayer's payment or property transfer, the taxpayer's charitable contribution deduction must be reduced. The proposed rules do not specify how to determine the amount of this reduction.

    The IRS and Treasury justify the distinction between state or local credits and deductions on the grounds that the benefit of a dollar-for-dollar deduction is limited to the taxpayer's state and local marginal rate. As a result, the risk of a deduction being used to circumvent the new SALT cap is comparatively low

Additionally, the proposed regulations note that the treatment of state or local tax deductions for charitable contributions as a *quid pro quo* benefit would pose an administrative burden for both taxpayers and the IRS by making the calculation of federal and state and local taxes difficult. This is because the value of a deduction varies based on the taxpayer's marginal or effective state and local tax rates.

EXAMPLES:

Example A: State X grants taxpayers a 70 percent state tax credit for payment of contributions to an eligible entity under Section 170(c). The taxpayer contributes $1,000 to an eligible entity and the taxpayer receives a $700 state or local tax credit. The taxpayer must reduce the $1,000 contribution by the $700 state tax credit, leaving an allowable contribution deduction of $300 on the taxpayer's federal income tax return. The proposed regulations also apply to payments made by trusts or decedents' estates in determining the amount of their contribution deduction.

Example B: An individual contributes $1,000 to an eligible charitable entity and in exchange receives a state tax deduction equal to the amount contributed to the entity. The individual is not required to reduce the federal charitable contribution deduction on account of the state tax deduction because it is not a quid pro quo transaction.

***De Minimis* Exception.** The IRS and Treasury provide a *de minimis* exception to the proposed regulations limiting the availability of a charitable contribution deduction when a taxpayer receives a state or local tax credit in exchange for payments to a charitable organization.

Generally, taxpayers may disregard a state or local tax credit if the credit does not exceed 15 percent of the taxpayer's payment or fair market value of the property transferred by the taxpayer to a charitable organization. As a result, if a state or local tax credit is not greater than 15 percent, it will not reduce the taxpayer's federal deduction for a charitable contribution.

The *de minimis* exception is intended to provide consistent treatment between state or local tax credits that provide a benefit equivalent to state or local tax deductions.

EXAMPLE:

A taxpayer makes a $1,000 contribution to an eligible entity and receives a state tax credit of $100. The taxpayer is not required to reduce the $1,000 deduction by the value of the credit because it is less than 15 percent of the fair market value of the contribution. The taxpayer may include the $1,000 contribution as a charitable deduction on the taxpayer's federal income tax return.

2. **An "Opt-Out" Mechanism.** The proposed regulations also consider a potential rule that would allow a taxpayer to decline the receipt or anticipated receipt of a state or local tax credit at the time of the taxpayer's payment or transfer to a charitable organization. While the proposed regulations do not include any details on such an opt-out mechanism, the intent behind this proposal would be to allow taxpayers to choose to receive the full benefits of a charitable contribution deduction if they refuse the value of a state or local tax credit.

Request for Comments

The IRS and Treasury have asked for written comments on the published guidance within 45 days of the date the proposed regulations are published in the *Federal Register*. We anticipate that the comments will be due in early October. A public hearing has also been scheduled for Nov. 5, 2018, at 10 a.m.

Specifically, comments have been requested on the following aspects of the proposed regulations including:

1. Whether there should be recognition of gain or loss when property is transferred in consideration for state or local tax credits that are not *de minimis*;
2. Determination of the basis of a transferable tax credit that a taxpayer sells or exchanges;
3. Procedures by which a taxpayer may establish that the taxpayer declined receipt of the state or local tax credit;
4. Substantiation and reporting requirements for donors and donees making or receiving payments or transfers of property in return for state and local tax credits;
5. Suggestions for calculating the reduction to the charitable contribution deduction for a taxpayer that receives or a state or local tax deduction in an amount that exceeds the amount of the taxpayer's payment or the fair market value of the property transferred to an entity listed in section 170(c);
6. Whether the regulations should address other state or local tax benefits, such as tax exclusions, that may be provided as consideration for certain payments or transfers to an entity listed in section 170(c);
7. Potential compliance savings, compliance costs, costs related to increased tax planning, or any effects on charitable contribution decisions that may occur; and
8. Impact on contributions to state and local tax credit programs.

Impact and Next Steps

The proposed regulations will have a significant impact on tax-exempt organizations, state and local government credit programs and charitable giving decisions. We believe that it is important for individuals and entities affected by these proposed regulations to engage in the rulemaking process. The IRS and Treasury have specifically asked for comments on how these rules will impact charitable giving and whether taxpayers and other affected organizations will face compliance burdens. It is important that they hear from all stakeholders on the scope and impact of the proposed rules.

Our Federal Tax Policy team can assist as you consider the impact that these rules may have for you. Our team has significant knowledge on the taxation of exempt organizations as well as significant experience with the rulemaking process. To the extent questions are unanswered or the rules are not clear, our team can create a dialogue with policymakers to help get your issues resolved. By doing so, policymakers will have a better understanding of the impact these rules will have on individuals and exempt organizations and the challenges you may face in trying to implement them.

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