Final Regulations on Charitable Contributions and State and Local Tax (SALT) Credits

Summary of Treasury Decision 9864

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Final Regulations on Charitable Contributions and State and Local Tax (SALT) Credits

Effective date of Final Regulations: August 12, 2019

Applies to: Charitable contributions made after August 27, 2018 for which taxpayer receives a state or local tax credit.

This presentation:

- What is SALT
- Overview of Developments
- Impact on States and their Responses
- Final Regulations
- Safe Harbor 1 – SALT Under the Cap
- Safe Harbor 2 – Applications to Business
- Future Outlook

WHAT IS SALT

SALT Defined

State and Local Tax

- From: IRC § 164 – Itemized Deductions

  (a) **General rule**. Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

  (1) State and local, and foreign, real property taxes.

  (2) State and local personal property taxes.

  (3) State and local, and foreign, income, war profits, and excess profits taxes.

  (4) The GST tax imposed on income distributions.

OVERVIEW OF DEVELOPMENTS

Overview of Developments

1. Before the Tax Cuts and Jobs Act - Uncapped SALT deduction

2. TCJA -
   - Effective December 31, 2017
   - IRC § 164(b)(6) - limits SALT deductions to $10,000 ($5,000 married filing separately)
     - Recall § 164(a) – large impact items: real property tax; state income tax
     - Applies to individuals, not business entities
     - *Does not apply to* (i) real property and personal property tax incurred in carrying on a trade or business or activity described in Section 212*, or (ii) foreign taxes
   - Stated intent - broaden individual income tax base and partially fund reduction in rates

3. States Responses - Workarounds; Lawsuits

4. Proposed Regulations - August 27, 2018 83 FR 43563

5. Final Regulations – Effective August 12, 2019

* § 212. Expenses for production of income. In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
(1) for the production or collection of income;
(2) for the management, conservation, or maintenance of property held for the production of income; or
(3) in connection with the determination, collection, or refund of any tax.

SALT Cap - Basic Example

Application of SALT cap

- Married filing jointly, itemizing deductions

	2017	2018	Change in SALT deductions
Property Tax	$ 6,400	$6,600	$200
State Income Tax	$11,200	$11,800	$600
TOTAL SALT Deductions:	$17,600	**CAP: $ 10,000**	**($7,600)**

- Even though SALT deductions would otherwise have increased by $800 from 2017 to 2018, due to the SALT cap, taxpayer only permitted to take $10,000 in SALT deductions, a $7,600 decrease from prior year

IMPACT ON STATES AND THEIR RESPONSES

Impact on States and Their Responses

State Impact

- Taxpayers of 19 states and D.C. average more than $10,000 in SALT deductions (PEW study)

State Responses

- Common Workaround: State gives tax credits for § 170(c) payments made by taxpayer to a state-formed organization; taxpayer takes charitable contribution deduction on federal return to replace lost SALT deduction

  - IRC § 170. Charitable, etc., contributions and gifts

    (a) Allowance of deduction

    (1) General rule. There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary.

    (c) Charitable contribution defined. For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of—

    (1) A State,... or any political subdivision of any of the foregoing, … but only if the contribution or gift is made for exclusively public purposes

    (2) A corporation, trust… or foundation… organized and operated exclusively for religious, charitable, [… etc. …] purposes… no part of the net earnings of which inures to the benefit of any private shareholder… (i.e., non-profit organization)

Impact on States and Their Responses

Workaround example:

- Taxpayer (TP) has $25,000 in SALT deductions, which are capped at $10,000 under IRC § 164(b)(6), resulting in $15,000 lost deductions
- TP makes a donation to a State program in the amount of the lost deductions and the State gives TP a dollar for dollar credit (for ease of example, though more typically State gives a percentage of donation (e.g., tax credit = 90% of donation));
- TP's position is cash neutral at the state level, and at the federal level, TP uses a charitable contribution deduction to recoup the lost SALT deductions

SALT	§ 170(c)	State	CCD
$25,000-d			
$10,000 CAP			
($15,000) d			
	($15,000) C	15,000 C	$15,000 d*

CCD = charitable contribution deduction | C = cash value | d = deduction value

* Note that CCD has historically (prior to new regs) been allowed, notwithstanding TP's receipt of state tax credit

Impact on States and Their Responses

State Responses (following SALT cap, but prior to final regs)

- **California** – CA State College Access Tax Credit program (then-existing program) - S.B. 539 would have increased the tax credit awarded to taxpayers from 50 percent to 75 percent in return for donations to the program, and would have doubled the size of the program from $500 million annually to $1 billion. (Vetoed by Gov. Brown in October 2018 in response to proposed regs)
- **New Jersey** - S. 1893, executed May 2018, authorizes municipalities, counties, and school districts to establish charitable funds for specific public purposes, which can include public safety, capital improvements, public works, and other purposes. Taxpayers who donate to a fund can receive a 90% credit toward their property tax bills, and the contributions can be claimed as charitable deductions. Following the proposed Regs, NJ offered TPs the option to elect a 15% credit to stay within Regs.
- **New York** – New York State Charitable Gifts Trust Fund (new trust fund established in 2018) – up to 85% tax credit for donations made to the fund
    - "We are confident that our recently enacted opportunities for charitable contributions to New York State and local governments are consistent with federal law and follow well-established precedent, and I have made it very clear that we will use every tool at our disposal, including litigation, to fight back to ensure New Yorkers aren't being used as a piggy bank to pay for tax cuts for big corporations." – New York Gov. Andrew Cuomo

Impact on States and Their Responses

State Responses (cont'd)

- **Georgia** – Rural Hospital Tax Credit (eff. 1.1.2017) - O.C.G.A. § 48-7-29.20
  - Donated funds can be used by hospitals in need for renovations, new construction, feasibility studies for new treatment centers, pay construction loans, pay down debt, pay administrative expenses (but not executive compensation)
  - Individual credit limited to lesser of 90% actually expended or $5,000 individual, or $10,000 married filing joint; cannot exceed TP's current income tax liability, but 5 year carryover is available
  - Corporate credit limited to lesser of 90% of actual amount expended, the amount preapproved for donation by Georgia, and 75% of tax liability
- **Connecticut** – new state income tax at partnership entity level based on net receipts and corresponding state tax credit to members (partnership tax is deductible by the passthrough, though it would be disallowed by the individual)
  - WI, LA, OK and RI followed suit (entity level tax is optional, not mandatory)

Impact on States and Their Responses

Lawsuits

- NY, CT, MD and NJ filed suit in the Southern District of NY on July 17, 2018 - state sovereignty argument (if states tax and federal government (effectively) taxes again, states' ability to maintain their tax and fiscal policies is more difficult, "hobbling their sovereign authority to make policy decisions without federal interference") Case 1:18-cv-06427. Oral argument heard on June 18, 2019 and decision reserved.

- New lawsuit filed July 17, 2019 regarding final Regs.
  - "The final IRS rule flies in the face of a century of federal tax law that says state choices to provide tax incentives for charitable donations do not affect the federal deductibility of those gifts." - NY Governor Andrew Cuomo

FINAL REGULATIONS

Final Regulations

Treasury Decision 9864

- Effective August 12, 2019
- Applies to contributions made after August 27, 2018 (i.e., the date of the proposed regulations)
- Under Section 170 of the IRC (Charitable Contributions and Gifts) and Section 642 (similar application to payments made by trust or decedent's estate)
- *Quid Pro Quo* – this is the fundamental rule set forth by the regs: taxpayers can only take a charitable contribution deduction in the amount, if any, by which their § 170(c) payment exceeds the state and local tax credit they receive in return for such payment (i.e., if TP is getting a benefit in return for its § 170(c) payment , then it's not really a gift and can't be deducted as such)
- *De Minimis Exception* - if the tax credit is for 15% or less of TP's payment, TP can take full amount as charitable contribution deduction on federal return
- *Deductions (compared to credits)* – charitable contribution in exchange for state and local *deductions* may be taken as federal deductions unless it exceeds the taxpayer's donation

Reasoning

- "Upon careful review of the issue, the Treasury Department and the IRS have determined that **longstanding principles** under section 170 should guide the tax treatment of these contributions. Section 170 provides a deduction for taxpayers' gratuitous payments to qualifying entities, not for transfers that result in receipt of valuable economic benefits." –TD 9864

Final Regulations

Reasoning - Background in TD 9864:

(1) IRS argues position that precedent establishes *quid pro quo* rule:

- Citing Rev. Rul. 67-246 – two-part test for determining whether the taxpayer is entitled to a charitable contribution deduction when TP receives benefit in connection with donation: (1) payment to charity must exceed the market value of benefits received, and (2) TP must show it paid the excess with the intention of making a gift
- Citing *United States* v. *American Bar Endowment,* 477 U.S. 105, 116-18 (1986) - "*sine qua non* of a charitable contribution is a transfer of money or property without adequate consideration" (the Court concluding that deduction is allowed only to the extent the donation exceeds fair market value of benefit received).
- Citing *Hernandez* v. *Commissioner,* 490 U.S. 680, 690 (1989) – Court holding that payments to a charity that entitled the taxpayers to receive an identifiable benefit in return for their money were part of a "quintessential quid pro quo exchange," and thus, were not contributions or gifts within the meaning of section 170.
- Recognizing that the aforementioned authority did not specifically pertain to whether state or local tax credit should be treated as a return benefit in exchange for a donation: "[t]he Treasury Department and the IRS did not publish formal guidance on this question before the enactment of the limitation under section 164(b)(6)"

Final Regulations

Reasoning - Background in TD 9864 (cont'd):

(2) Recognizing prior findings to the contrary:

- "In 2010, however, the IRS Chief Counsel advised that, under certain circumstances, a **taxpayer may take a deduction under section 170 for the full amount of a contribution made in exchange for a state tax credit, without subtracting the value of the credit received in return**. See CCA 201105010 (Oct. 27, 2010). IRS Chief Counsel has also taken the position in Tax Court litigation that the amount of a state or local tax credit that reduces a tax liability is not an accession to wealth includible in income under section 61 or an amount realized for purposes of section 1001. In these cases, the Tax Court agreed with the Chief Counsel's position. See, for example, *Maines v. Commissioner*, 144 T.C. 123, 134 (2015); *Tempel v. Commissioner*, 136 T.C. 341, 351-54 (2011); aff'd sub nom. *Esgar Corp. v. Commissioner*, 744 F.3d 648 (10th Cir. 2014)." [emphasis added]

Final Regulations

Reasoning - Background in TD 9864 (cont'd):

(2) Recognizing prior findings to the contrary (cont'd):

- CCA 201105010 (Oct. 27, 2010) - "This office has previously analyzed this issue in the context of similar charitable credits. Specifically, we have analyzed the donation of cash to a state agency, in exchange for state charitable tax credits, and we have analyzed the donation of property to a state agency or to a § 501(c)(3) organization, in exchange for refundable and transferable state charitable tax credits. In both instances we did not resolve the issue, but instead suggested that the issue could be addressed in official published guidance. At this time, published guidance on the issue is not contemplated. Based on our analysis of existing authorities, we conclude that the position reflected in McLennan, Browning, and similar case law generally applies. There may be unusual circumstances in which it would be appropriate to recharacterize a payment of cash or property that was, in form, a charitable contribution as, in substance, a satisfaction of tax liability. **Generally, however, a state or local tax benefit is treated for federal tax purposes as a reduction or potential reduction in tax liability. As such, it is reflected in a reduced deduction for the payment of state or local tax under § 164, not as consideration that might constitute a quid pro quo, for purposes of § 170, or an amount realized includible in income, for purposes of §§ 61 and 1001**…" (citing additional revenue rulings and case law) [emphasis added]

Final Regulations

Reasoning - Background in TD 9864 (cont'd):

(3) Concluding that 2010 CCA does not control and precedent supports *quid pro quo* rule:

- "Upon reviewing the authorities under section 170, the Treasury Department and the IRS questioned the reasoning of the 2010 CCA." (i.e., via the 2018 proposed regulations)
- Specifically addressed CCAs and noted that **CCAs are not official rulings or positions of the IRS and cannot be cited as precedent**, and that certain CCAs addressing the matter declined to provide special guidance and suggested formal guidance to address the question.

IRS also considered in the final regs:

- Donations to third parties, but found that expectation to receive a substantial benefit, even if from a third party, constitutes *quid pro quo*.
- Potentially more favorable treatment to businesses, but found that businesses and individuals are treated the same under § 170; it is § 162 that permits a business to deduct expenses (see Safe Harbor 2 below)

Final Regulations

IRS Expressly Discussed

- Application to pre-existing state programs:
  - "Neither the intent of the section 170(c) organization, nor the date of enactment of a particular state tax credit program, are relevant to the application of the *quid pro quo* principle. **Accordingly, the final regulations apply the rules equally to all state and local tax credit programs**, and the final regulations do not adopt commenter recommendations to create exceptions to the general rule for various types of state tax credit programs." [emphasis added]

SAFE HARBOR 1 – UNDER SALT CAP

Under SALT Cap

Notice 2019-12

- If Taxpayer is under SALT deduction cap and makes a § 170(c) donation in exchange for tax credits, federal charitable contribution deduction is disallowed, and TP also loses SALT deduction to which it would otherwise be entitled.
- The safe harbor thus provides that in certain circumstances TP can treat disallowed charitable contribution deduction as SALT deduction, not in excess of its current year tax liability (but excess can be carried forward)

Example (simple, no carry forward):

SALT	170(c)	State	CCD
$8,000-d			
(2,000)-d	($,2000)-C	2,000–C	~~$2,000-d~~ *

CCD = charitable contribution deduction | C = cash | d = deduction

* CCD disallowed due to Regs (*quid pro quo*)

1. TP has $8,000 in SALT deductions
2. TP makes $2,000 donation to 170(c) organization in exchange for $2,000 state tax credit (net zero cash effect); however, SALT deduction is reduced by $2,000 and $2,000 CCD is disallowed due to *quid pro quo*, thus net effect on deductions is that TP would lose $2,000 in deductions, but due to safe harbor, TP permitted to treat the donation as a SALT payment and thus retain same amount of deductions (i.e., TP doesn't make out any worse due to donation)

SAFE HARBOR 2 – BUSINESS EXCEPTIONS

Business Exceptions

SALT Cap

- Does not apply to business entities, or to individuals engaged in a trade or business (with respect to real property and personal property taxes)
  - § 164(b)(6) "Limitation on individual deductions for taxable years 2018 through 2025. In the case of an **individual**…"
  - "…The preceding sentence shall not apply to any foreign taxes described in subsection (a)(3) or to any taxes described in paragraph (1) [real property] and (2) [personal property] of subsection (a) **which are paid or accrued in carrying on a trade or business or an activity described in section 212**" [emphasis added]

Tax Credits for § 170(c) Payments?

- **Safe Harbor - Rev. Proc. 2019-12** - in certain circumstances, business entity can deduct charitable contributions as ordinary and necessary business expenses under § 162*
  1. C Corps - Section 3.02 of Rev. Proc.:
     - C Corp can deduct a donation under § 162(a) as an ordinary and necessary business expense if the donation is made to an organization described in Section 170(c) and C Corp expects to receive a state or local tax credit, to the extent of the credit so received.

* 162 (a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

Business Exceptions

- Safe Harbor - Rev. Proc. 2019-12 (cont'd)
  2. Specified Passthrough Entities - Section 4.02 of Rev. Proc.:
     - "Specified Passthrough Entity":
       (1) a business entity other than a C corp that is regarded for all federal income tax purposes as separate from owner under section 301.7701-3 * (e.g., partnership or S corp, but not single member LLC);
       (2) operates a trade or business within the meaning of section 162**;
       (3) the entity is subject to state or local tax imposed directly on the entity; and
       (4) makes a payment to an organization described in 170(c) and receives or expects to receive a state or local tax credit to offset state or local tax incurred directly **by such entity** in carrying on its trade or business other than state or local income tax (e.g., real property tax, excise tax, if state law imposes at the entity level)
     - If a Specified Passthrough Entity makes a payment to a 170(c) organization and receives or expects to receive a tax credit to offset state or local tax of such entity (other than state or local income tax), the entity may treat the donation as an ordinary and necessary business expense under 162(a) to the extent of the credit so received.

* Classification of certain business entities

** "Trade or business" not defined in 162; made on a case by case basis, but IRS.gov provides: "The term trade or business generally includes any activity carried on for the production of income from selling goods or performing services. " The Supreme Court has found that profit motive and activity over time are relevant factors.

FUTURE OUTLOOK

Future Outlook

Anything safe under new regs?

- Those willing to make a charitable contribution for a de minimis (15% or less of the amount of the contribution) tax credit
- Individuals under SALT cap get the deductible benefit of their charitable contributions (up to the SALT cap)
- C Corps with respect to state tax credit programs (and partnerships and S corps if they can meet certain requirements)
- Trade or business with respect to SALT cap

Pre-existing programs?

- Under fire – expressly called out in regs as not exempt

Done deal?

- Lawsuit by NY, NJ, CT yet unresolved
- Struck down as ex post facto? Not likely given proposed regulations in August 2018
- Keep an eye on Connecticut plan –
  - Arguably, it works under new regs, however latest IRS Priority Guidance Plan (released June 17, 2019) includes item regarding applying SALT deduction cap to passthrough entities
  - Substance over form challenge? (proponents for CT plan argue no, tax is being shifted in substance *and* form to another taxpayer)

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