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Blue States Try to Rescue SALT Deductions With Charitable Contributions

Tax Reform Update

The so-called *Tax Cuts and Jobs Act* signed into law on December 22, 2017, changed the landscape for state taxation of individuals in one very significant way: starting this tax year, individual taxpayers can only deduct up to $10,000 of state income and property tax as an itemized deduction on Schedule A of their Forms 1040.[1] Consequently, state and locals taxes effectively became as much as 37 percent more expensive for many individual taxpayers, some of whom will no doubt continue to itemize notwithstanding the increase in the standard deduction. This monumental change in tax policy will have the following immediate consequences:

1. High-income individuals in high tax (mostly “coastal” and mostly “blue”) states will see a material increase in their actual out-of-pocket cost of state/local taxation.
2. As a result of an increased cost on such high-income individuals, state and local governments may find it harder to raise taxes and to settle disputed tax liabilities.
3. Politicians in blue states will interpret the federal tax policy change as a direct attack on their ability to govern for the general welfare of their citizens, especially at time when the federal government is retreating from its support for health care and other social services.

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These three intended consequences, driven entirely by the GOP without any support from democrats, is already a catalyst for action in state capitals. High-income individuals don't usually welcome tax changes that hurt their pocket books. Democratic state and local politicians don't like to see their hands tied by congressional republicans.

Blue States Respond

Indeed, in the last few weeks New York[2], California[3], New Jersey[4] and other "blue" states are already developing a work-around that has been used, surprisingly rather sparingly, by a few other jurisdictions. The nature of many current proposals center around a general theme of allowing individuals to reduce their non-deductible state and local tax obligations if they make a (hopefully) tax-deductible charitable contribution to a charity that is created by the state and dedicated to reducing the burdens that would otherwise be imposed on state/local governments.[5] Often the credit against state taxes is not a dollar-for-dollar trade off as only a percentage (75-85 percent) of the charitable contribution can be claimed as a credit against state taxes.[6]

States' Tax Position May Be Uncertain, But Hardly "Ridiculous"

However, the proper federal tax characterization of contributions to such a charity "in exchange for" potentially offsetting Tax Credits is certainly not crystal clear. Similarly, it is easy to imagine the IRS looking askance at a charitable receipt indicating that "no goods or services were received as a quid pro quo for the contribution" when the donation entitled the donor to an offsetting tax credit.

Specifically, contributions to tax-exempt charities are deductible by the donor, subject to various limitations. [7] However, there is a line of authority under which, to be deductible as a charitable contribution, a transfer to a charitable organization (or government unit) must be a *gift* — i.e., a transfer without receipt of adequate consideration and made with charitable intent. A transfer generally is not considered made with the requisite charitable intent if the transferor expects or receives a direct or indirect return benefit commensurate with the amount of the donation. Where the taxpayer/donor does receive a benefit in exchange for the transfer to a charitable organization, the transfer may still be deductible as a charitable contribution, but only to the extent the amount donated

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exceeds the fair market value of the benefit received, and probably only then if the excess amount was transferred with the intent of making a gift. *See, United States v. American Bar Endowment*, 477 U.S. 105, 116-118 (1986); *Hernandez v. Commissioner*, 490 U.S. 680, 689-691 (1989); Treas. Reg. § 1.170A-1(h)(1)(2). Stated differently, if the benefits received or expected to be received by a donor are substantial (*i.e.*, greater than the incidental benefits that inure to the general public), then the transferor has arguably received a "quid pro quo" sufficient to preclude all or part of the charitable contribution deduction for federal income tax purposes. *Singer Co. v. U.S.*, 449 F.2d 413, 422-423 (Ct. Cl. 1971).

To the extent that donors receive "property" in exchange for their contribution, *e.g.*, in the form of some sort of credit that can be used to reduce their state or local tax liability, it is easy to imagine the IRS concluding that the tax credit is a quid pro quo benefit that precludes a charitable contribution deduction.

Treasury Department Guidance

The IRS has informally considered this issue in three pronouncements of interest, none of which is binding precedent on which other taxpayers can rely.

In CCA (Chief Counsel Advice of the IRS legal counsel[8]) 200435001, the IRS considered contributions made to support the Oregon childcare tax credit program that generates Oregon tax credits in a manner analogous to the IDA program. *See* ORS 315.213. Contributions may be made directly to the Childcare Division of the Employment Department or to selected tax-exempt nonprofits that provide services related to childcare, community development, etc. In this IRS guidance, released some 18 years ago, the IRS concluded that it was simply unclear whether the taxpayer/donor was entitled to a charitable contribution deduction on its federal return or was simply entitled to a deduction for state taxes when they used the certificate to satisfy their Oregon tax obligation. *See, also*, CCA 200238047 (Colorado Conservation Easement Credit.)[9]

More recently, in CCA 201105010 considered a state law that funded a number of programs using tax credits as incentives. A taxpayer that met the statutory provisions of a particular credit was eligible to receive state tax credits and the credits offset various state tax liabilities, including the state's individual income tax. In each case, the recipient of funds was a

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government or charitable entity that is eligible to receive deductible charitable contributions under section 170(c). The IRS noted that the tax benefit of a federal or state charitable contribution deduction is not regarded as a return benefit that negates charitable intent. The IRS held that taxpayers could take a section 170 charitable deduction for the full amount of their contributions to the government or charitable entity.

In a private letter ruling, the IRS ruled that a taxpayer who *purchased* state-energy tax credits was entitled to a deduction for state income taxes paid or accrued when such credits were applied to reduce the taxpayer's state tax liability.[10] This ruling is relevant to our analysis because it implies that the tax credit certificate was itself property.

In sum, there does not seem to be a dispositive legal answer to the question of whether the states are developing an alternative that has a realistic chance of surviving IRS scrutiny.

The lack of legal clarity on this issue did not stop Treasury Secretary Mnuchen from criticizing the strategy as "ridiculous" at a White House press briefing in mid January.[11]

Other Treasury officials have been less absolute in their assessment, generally expressing reservations about allowing tax-deductible donations to state-affiliated charities to support SALT credits in that state without pejorative commentary. For example, *Tax Notes* has reported that, on January 25, Treasury Tax Legislative Counsel (Thomas West said that his department is monitoring proposals in several high-tax states to effectively waive a taxpayer's state tax obligations if they donate to state-operated charities in exchange for state credits and the federal charitable deduction. West expressed skepticism about the appropriateness of such efforts, variations of which have been cropping up recently in different states.[12] Significantly, he added: "Personally, I think as you get closer to a one-to-one benefit for a contribution, that becomes something" other than a charitable donation. West reminded his audience that he was offering his own assessment and not the Treasury's official position, adding that the department would continue "to monitor developments as they happen across states."[13]

The same article quotes Elinor Ramey, an attorney-adviser in the Treasury Office of Tax Legislative Counsel as noting "This [SALT credits

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in exchange for charitable contributions] is something that is concerning, but we're looking at it," when she was asked about the proposals. Echoing West, Ramey said Treasury is concerned about protecting the fisc and ensuring that the tax code is properly administered. She declined to say whether Treasury intends to issue a notice on the charitable donation workaround.

Which Leaves Taxpayers Where Exactly?

Published but non-binding Treasury Department guidance, in the form of CCAs and PLRs, seem to support the state efforts to obviate the harshest consequences of limiting individuals' deductibility for state taxes. Treasury and IRS are clearly watching, and undoubtedly re-examining its prior position. But will the IRS really take on tens of thousands of taxpayers (a/k/a registered voters) from blue states who participate in state-sponsored programs? Stay tuned.

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[1] P.L. 115-97 Section 11042, adding IRC section 164(b)(6). Married individuals filing separate returns are limited to $5,000.

[2] On February 15, Gov. Cuomo of NY introduced legislation that provided several provisions designed to alter NYS tax laws in an effort to "protect New Yorkers" from the TCJA limitations on state taxation, including a proposal to create two state charitable contributions funds that provide donors with a tax credit equal to 85-95 percent of their donation. The proposal also includes several other techniques, including an unincorporated business tax that would offset tax obligations of the equity owners. Jones, P., *Legislation Aims to Shield New Yorkers From Federal Tax Changes*, Tax Notes; State Tax Today 2/20/18.

[3] On January 4, Senate President Pro Tempore Kevin de León (D) introduced California's bill (S.B. 227), which would allow residents to make charitable contributions to a new California Excellence Fund to be used for public purposes specified under IRC section 170. Taxpayers could claim the amount as a *dollar-for-dollar tax credit* against state income taxes owed, and presumably would also claim a charitable contribution

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deduction from their federal taxes. See Loricchio, L., *High-Tax States Seek to Mitigate Fallout of Federal Tax Bill,* Tax Notes; State Tax Today 1/8/18.

[4] On February 26, the New Jersey Senate passed a bill that would allow local governments to accept property taxes in the form of charitable contributions. The legislation would authorize municipalities, counties and school districts to create charitable funds that could be used as a revenue source. The local governments could give tax credits to residents who contribute to the fund, allowing them to offset their own property tax bills — up to 90 percent — and take a write-off on their federal income taxes. See Hutchins, R., "Senate Passes SALT Workaround as GOP Raises Concerns," Politico 2/26/18.

[5] The Connecticut Department of Revenue Services borrows from one of the NYS proposals but does not allow charitable contributions to support SALT credits. Rather, Connecticut has proposed S.B. 11, an entity-level tax on the net income of pass-through businesses and an offsetting individual income tax credit for the entity's members. Taking advantage of the fact that the new SALT cap does not apply to businesses, the proposal would effectively shift back to Connecticut residents a projected $600 million in otherwise lost SALT deductions. Hamilton, A., *Connecticut Finds a SALT Workaround That Would Actually Work,* Tax Notes; State Tax Today 2/26/18.

[6] Many taxpayers are already familiar with a variation of this "game" if they live in wealthy suburbs with school systems that rely on tax revenue supplemented to varying degrees by voluntary donations to the local school fund.

[7] The specific limitations on deductibility of charitable contributions is beyond the scope of this article. It is sufficient to simply note that many taxpayers will benefit if they can use a contribution to a charity to "convert" state taxes into charitable contributions.

[8] A CCA is merely the opinion of one lawyer in the IRS Chief Counsel's Office. It was issued to a local IRS office in response to an inquiry concerning whether contributions made to the Oregon childcare tax credit program qualified for a charitable contribution deduction. The letter was issued only in an advisory capacity and is not binding on the IRS or the taxpayers involved. The author recommended that the IRS National

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Office carefully consider the issues presented in its pending examination of other issues related to the treatment of state tax credits.

[9] CCA 200238047 supplements CCA 200238041.

[10] PLR 200348002. Unfortunately, private letter rulings also are not binding precedent.

[11] Curry, J., *Mnuchin Dismisses SALT Workarounds, Charitable Giving Concerns,* Tax Notes; State Tax Today 1/12/18.

In January, Treasury Secretary Steven Mnuchin called some of the floated SALT cap workarounds ridiculous, presumably including the charitable deduction workaround, where a taxpayer would be able to reclassify a state tax payment as a charitable deduction by directing it to a state-created charitable fund. It is unclear whether Secretary Mnuchin was even aware of the authorities cited in this article when he offered his assessment.

[12] Stokeld, F., *Treasury Monitoring State Proposals on Charitable Donations and State Taxes,* Tax Notes; State Tax Today 1/26/18.

[13] Id.

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