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Charitable Contributions

INSIGHT: IRS Proposed Regulations Take the Bite Out of State Workarounds of SALT Deduction Cap

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One of the most publicized changes made by the Tax Cuts and Jobs Act, signed into law in December 2017, was the $10,000 cap placed on the total amount an individual taxpayer could claim as an itemized deduction for personal state and local income, sales and property taxes (the ''SALT deduction''). Previously, the personal SALT deduction was unlimited.

In response to the SALT deduction cap, a number of high tax states, including Connecticut and New York, proposed workarounds to help ease the impact of this cap for taxpayers who pay more than $10,000 of SALT taxes. For example, Connecticut law now permits Connecticut municipalities to create new charitable organizations that support town services and give a corresponding local property tax credit for amounts contributed to these organizations. New York has created a state-operated charitable contribution fund to which taxpayers can make donations in lieu of paying a percentage of their state income tax and permits municipalities to created charitable organizations to which taxpayers may make donations in exchange for property tax credits. The theory behind these laws was that these contributions would be treated as deductible charitable contributions for federal income tax purposes with no detriment to the state and local tax base.

To thwart the states' efforts to circumvent the SALT deduction cap, the Internal Revenue Service issued Notice 2018-54 in May 2018 to warn the states that federal law controls the proper characterization of contributions for federal income tax purposes and to announce its intention to ''propose regulations addressing the federal income tax treatment of certain payments made by taxpayers for which taxpayers receive a credit against their state and local taxes.''

On Aug. 23, 2018, the IRS followed through with its warning and released new proposed regulations that address the workarounds introduced by certain states. The premise of the proposed regulations is that a taxpayer should only be entitled to a charitable contribution deduction for a payment made to a qualifying charitable organization to the extent the taxpayer does not receive something of economic value in return (i.e., the ''quid pro quo doctrine''). Consistent with this premise, the proposed regulations make it clear that a charitable contribution deduction will only be permitted for federal tax purposes to the extent the contribution exceeds the amount of the state or local tax credit received in return for the contribution. As an example, the proposed regulations state that if an individual makes a $1,000 payment to a qualifying charitable organization and receives or is expected to receive a state tax credit equal to 70 percent of the payment, the individual's charitable contribution deduction for the payment may not exceed $300.

The proposed regulations provide a de minimis rule that permits a taxpayer to deduct the full amount of the payment as a charitable contribution deduction if the amount of the state or local tax credit received or expected to be received by the taxpayer does not exceed 15 percent of the payment. As an example, the pro-

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posed regulations state that if a taxpayer transfers a painting with a $100,000 fair market value to a qualifying charitable organization and receives or is expected to receive a state tax credit equal to 10 percent of the painting's fair market value, the taxpayer's charitable contribution deduction is not limited to the amount in excess of the state tax credit amount.

The proposed regulations make it clear that they apply to trusts and estates that make payments to a qualifying charitable organization in exchange for a state or local tax credit but do not apply to charitable contributions for which a taxpayer receives a state or local tax deduction. Certain issues are not addressed by 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) the 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; and (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.

One important consideration is that the SALT deduction cap does not apply to SALT payments made by businesses. Because these payments continue to be fully deductible for federal income tax purposes, a number of states have introduced new tax regimes that shift the SALT burden from individuals to businesses. For example, Connecticut recently imposed a new entity-level tax on most pass-through businesses (e.g., partnerships, S-corporations, and LLCs treated as partnerships) that did not previously pay Connecticut tax. Owners of an affected business are entitled to a partial credit against their income tax based on the owner's pro rata share of the entity tax paid by the pass-through business. New York recently implemented a voluntary employer payroll tax with an employee-side income tax credit in the same amount. These entity-level SALT expenses are fully deductible for federal income tax purposes and circumvent the SALT cap with little to no effect on state tax revenues.

Furthermore, the IRS recently announced that business taxpayers who make business-related payments to charities or government entities for which the taxpayers receive state and local tax credits can generally deduct the payments as a business expense for federal income tax purposes. The deduction is available regardless of whether the business taxpayer is doing business as a sole proprietor, partnership, or corporation, as long as the payment qualifies as an ordinary and necessary business expense.

The proposed regulations indicate that they apply to payments made after Aug. 27, 2018. However, taxpayers who made a payment pursuant to a charitable tax credit program before this effective date are not necessarily assured of a charitable contribution deduction for the entire payment. This is because the preamble to the proposed regulation states that the proposed regulations are based on longstanding federal tax law principles, which would include the quid pro quo doctrine.

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