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Final Regs Zap $10,000 Annual SALT Limitation Workaround

The IRS closes door on state tax credit legislation.

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The Internal Revenue Service just issued final regulations (final regs) which, consistent with the proposed regulations (proposed regs) issued last year, foreclose using charitable contributions as a workaround to circumvent the limitations on state and local taxes (SALT). The Joint Committee on Taxation estimated that the limitation on state and local tax deductions, along with certain other reforms of itemized deductions, would raise $668 billion over 10 years. The SALT limitation

provided a significant part of the funding for other tax cuts created under the Tax Cuts and Jobs Act. So, the IRS had to have been expected to protect that revenue stream, and it did. Only about 5% of taxpayers will have their state income tax deduction limited by the new SALT restrictions. But for that 5% of taxpayers affected, the impact will be costly.

The Act reduced or eliminated most itemized deductions from 2018 to 2026. Itplaced an annual $10,000 ($5,000 for married persons filing separately) limit on the deductibility of SALT payments under new Internal Revenue Code Section 164(b)(6). This new limitation prompted a number of states and political subdivisions to adopt legislation allowing residents to avoid the new $10,000 SALT cap by providing a credit against state and local taxes for contributions to certain charitable organizations recognized by state and local governments that support government functions. The purpose of such legislation was to recast non-deductible SALT payments as contributions that would be fully deductible under IRC Section 170(a) (once the new doubled standard deduction was exceeded).

Notice 2019-54

On May 23, 2018, the IRS forewarned its intention to eliminate the strategy advanced by states and political subdivisions to avoid the SALT cap in Notice 2018-54. The notice indicated that the guidance to be issued under the proposed regs would be limited to contributions to newly created state or local controlled charities formed in response to the SALT cap, as opposed to contributions in connection with those preexisting tax credit programs across the country intended to support a variety of charities and educational organizations that are independent of any state or local government control. Unfortunately, the broad approach in both the proposed and final regs isn't limited in that manner.

Proposed Regs

Prop. Reg. 1.170A-1(h)(3)(i) provided a flat-out rule, applicable to both newly created and preexisting tax credit programs, that "if a taxpayer makes a payment or

transfers property to or for the use of an entity listed in section 170(c), the amount of the taxpayer's charitable contribution deduction under section 170(c) is reduced by the amount of any state or local tax credit that the taxpayer receives or expects to receive in consideration for the taxpayer's payment or transfer." The proposed regs didn't differentiate between new laws that would permit residents to contribute to a government-run charity and obtain a tax credit and preexisting programs in which states provide tax credits for contributions to charities or educational institutions.

The theory underlying this position was "that when a taxpayer receive or expects to receive a state or local tax credit in return for payment or transfer to an entity listed in section 170(c), the receipt of this tax benefit constitutes a *quid pro quo* benefit that may preclude a full deduction under Section 170(a)."

De Minimus Exception

The proposed regs provided a de minimis exception under which the amount of a state or local tax credit doesn't reduce the otherwise available charitable income tax deduction when the amount of the credit doesn't exceed 15% of the taxpayer's payment or 15% of the fair market value (FMV) of the property transferred. Prop. Reg. 1.170A-1(h)(3)(vi).

The proposed and final regs provide that if a taxpayer makes a payment or transfers property and receives a state or local tax *deduction* (as opposed to a credit) that doesn't exceed the amount of the taxpayer's payment or the FMV of the property transferred, there's no reduction in the charitable deduction under Section 170(a). Reg. 1.170A-1(h)(3)(ii)(A).

Final Regs Restrict Workarounds

On June 11, 2019, the IRS issued final regs (TD 9864) confirming these harsh restriction on state and local workarounds.The final regs apply to amounts paid, or property transferred, after Aug.27, 2018 and make clarifying and technical changes to the proposed regs. The final regs remain broad in scope and make no distinction

between a contribution to a newly formed state-controlled entity and a contribution to a preexisting independent public charity.

If a taxpayer makes a payment, or transfers property, to or for the use of an entity described in Section 170(c), and the taxpayer receives, or expects to receive, a state or local tax credit in return for such payment, the tax credit constitutes a return benefit to the taxpayer, or quid pro quo, reducing the taxpayer's charitable contribution deduction. Reg. 1.170A-1(h)(3)(i).

Example: An individual, makes a payment of $1,000 to X, an entity described in Section 170(c). In exchange for the payment, A receives or expects to receive a state tax credit of 70% of the amount of A's payment to X. A's charitable contribution deduction is reduced by $700 (0.70 x $1,000). Thus, A's charitable contribution deduction for the $1,000 payment to X may not exceed $300.

The final regs include the same de minimis exception that was in the proposed regs. A state or local tax credit that doesn't exceed 15% of the amount of the contribution isn't a quid pro quo benefit and won't reduce the taxpayer's charitable contribution deduction. Reg. 1.170A-1(h)(3)(vi), Example 2.

Further, the final also clarify that the 15% exception applies if "total amount of the state and local tax credits," that is, the sum of such credits, received, or expected to be received, doesn't exceed 15% of the taxpayer's payment or 15% of the FMV of the property transferred by the taxpayer.

The final regs also retain the rule in the proposed regs that a taxpayer generally isn't required to reduce its charitable contribution deduction on account of its receipt of state or local tax *deductions* (as opposed to credits). The final regs retain the exception to this rule in the proposed regs for "excess state or local tax deductions." Reg. 1.170A-1(h)(3)(ii)(B).

Additionally, the final regs retain the provision in the proposed regs whereby the restrictions apply to payments made by a trustor a decedent's estate, in determining

its charitable contribution deduction under IRC Section 642(c). Treas. Regs. 1.170A-1(h)(3); Treas. Regs. 1.642(c)-3(g), applicable to payments of gross income after Aug. 27, 2018. Trusts and estates may qualify for a charitable contribution deduction under Section 642(c). This requires that the conditions of that section are met, including that the amount paid is from gross income, paid pursuant to the terms of the governing instrumen, and is for a purpose specified in Section 170(c). Thus, the same quid pro quo rules under Reg. 1.170A-1(h)(3) apply when a trust or estate makes a charitable contribution resulting in state or local tax credit in return for the contribution.

Safe Harbor

On the same date that TD 9864 was issued, the IRS issued Notice 2019-12, announcing that proposed regs will be issued to provide a safe harbor for individuals who make a payment to or for the use of an entity described in Section 170(c) in return for a state or local tax credit. Under the safe harbor, an individual who itemizes deductions and who makes a payment to a Section 170(c) entity in return for a state or local tax credit may treat as a payment of state or local tax for purposes of Section 164 the portion of such payment for which a charitable contribution deduction under Section 170 is or will be disallowed under final regs.

Restrictions on State and Local Governments

The final regs restrict recent state and local government efforts seeking to circumvent the SALT limitation, their application also extends to preexisting programs in which state and local tax credits have been provided for donations to certain community organizations with the apparent consent of the IRS. Taxpayers have for years been claiming charitable contribution deductions notwithstanding the tax credits provided in return. Therefore, although the impetus for their issuance was recent legislative efforts to avoid the SALT cap, the purview of the final regs extends to preexisting tax credit programs aimed at encouraging donations to various charitable and educational institutions that have come to rely on such

programs for support and that now may be in jeopardy because of the elimination of the charitable deduction that historically has been available in this context.

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