Steve Leimberg's Income Tax Planning Email Newsletter Archive Message #180

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Subject: Richard L. Fox, Martin M. Shenkman & Jonathan Blattmachr - IRS Final Regulations Nullify $10,000 Annual SALT Limitation Workaround Attempts by States and Political Subdivisions

"Consistent with Notice 2018-54 and the proposed regulations previously issued by the IRS, and nullifying the annual $10,000 SALT limitation workaround attempts by a number of states and their political subdivision, the final regulations provide that a taxpayer who makes payments or transfers property to an entity eligible to receive tax deductible contributions must reduce their charitable deduction by the amount of any state or local tax credit the taxpayer receives or expects to receive. The final regulations generally retain the amendments set forth in the proposed regulations, with certain clarifying and technical changes."

Richard Fox, **Martin Shenkman** and **Jonathan Blattmachr** provide members with important and timely commentary on the final SALT regulations.

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Here is their commentary:

EXECUTIVE SUMMARY:

On June 11, 2019, the Treasury Department and the Internal Revenue Service issued final regulations (TD 9864, 6/11/2019) in response to legislation enacted by a number of states and their political subdivisions aimed at allowing their residents to avoid the $10,000 annual limitation on the deductibility of state and local tax (SALT) payments brought about under newly enacted Section 164(b)(6) under the Tax Cuts and Jobs Act. These legislative acts seek to allow taxpayers to claim a federal income tax charitable deduction for contributions to certain charitable organizations while permitting a credit against state or local income, real estate or other taxes otherwise imposed by such state or local tax governments in return for the contributions.

Some view this as an attempt by state and local governments to merely recast SALT payments as charitable contributions by providing state and local tax credits up to the full amount of the contributions, in effect providing an end-around the $10,000 annual deduction limitation on SALT payments that doesn't apply to charitable contributions. The issuance of the final regulations follows proposed regulations that were published on August 27, 2018, as well as IRS Notice 2018-54, which was released on May 23, 2018, in what essentially was a warning to taxpayers that such legislation wouldn't accomplish its intended purpose and taxpayers choosing this route might ultimately find themselves ultimately facing negative tax consequences.

Consistent with Notice 2018-54 and the proposed regulations, and effectively nullifying the SALT limitation legislative workaround attempts, the final regulations retain the general rule that 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 a *quid pro quo*, reducing the taxpayer's charitable contribution deduction for federal income tax purposes. The final regulations retain the *de minimis* exception provided in the proposed regulations, whereby a state or local tax credit that doesn't exceed 15 percent of the amount of the contribution isn't treated as a *quid pro quo* benefit and, therefore, doesn't reduce the taxpayer's charitable income tax deduction. However, the final regulations clarify that this 15 percent exception applies only if the sum of the taxpayer's state and local tax credits received, or expected to be received, does not exceed 15 percent of the taxpayer's payment or 15 percent of the fair market value of the property transferred by the taxpayer. Finally, the final regulations retain the provision in the proposed regulations, whereby the *quid pro quo* rules contained in the final regulations apply to payments made by a trust or a decedent's estate in determining its charitable contribution deduction under Section 642(c).

Like the proposed regulations, while the final regulations clearly target recently enacted state and local legislative efforts seeking to circumvent the new annual $10,000 SALT limitation, their application also extends to longstanding programs across the country in which state and local tax credits have been provided for donations to certain community organizations and private schools where, with the apparent blessing 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 regulations extends to preexisting tax credit programs (including those offered in many states for contributions of conservation easements described in Section 170(h)) 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.

FACTS:

Background

The Tax Cuts and Jobs Act ("Act"), signed into law on Dec. 22, 2017, made the most far reaching changes to the Internal Revenue Code in over 30 years. Among other significant changes is the elimination or limitation until 2026 of most itemized deductions that had been allowed for individuals for federal income tax purposes. The Act places an annual $10,000 ($5,000 for married persons filing separately) limit on the deductibility of SALT payments under new Section 164(b)(6). This new limitation has prompted a number of states and, in some cases, their political subdivisions, to adopt legislation seeking to allow their residents to avoid the new $10,000 annual deduction limitation or curb its impact by providing a credit against certain state and local taxes for contributions to certain newly created charitable organizations controlled by state and local governments that support government functions. The purpose of this legislation is to allow such contributions to be fully deductible under Section 170(a), notwithstanding the provision of state or local tax credits.

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, 2018-24 IRB 750 (5/23/2018), which provided background addressing the new SALT limitation and the legislation aimed at avoiding it:

> Section 11042 of "The Tax Cuts and Jobs Act [of 2017]," Pub. L. No. 115-97, limits an individual's deduction under § 164 for the aggregate amount of state and local taxes paid during the calendar year to $10,000 ($5,000 in the case of a married individual filing a separate return). State and local tax payments in excess of those amounts are not deductible. This new limitation applies to taxable years beginning after December 31, 2017, and before January 1, 2026. In response to this new limitation, some state legislatures are considering or have adopted legislative proposals that would allow taxpayers to make transfers to funds controlled by state or local governments, or other transferees specified by the state, in exchange for credits against the state or local taxes that the taxpayer is required to pay. The aim of these proposals is to allow taxpayers to characterize such transfers as fully deductible charitable contributions for federal income tax purposes, while using the same transfers to satisfy state or local tax liabilities.

Notice 2018-54 stated that the "Treasury Department and the IRS intend to propose regulations addressing the federal income tax treatment of transfers to funds controlled by state and local governments (or other state-specified transferees) that the transferor can treat in whole or in part as satisfying state and local tax obligations." Thus, the notice indicated that the guidance to be issued under the proposed regulations 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.

Issuance of Proposed Regulations

Shortly after the issuance of Notice 2018-54, proposed regulations (REG-112176-18) were published on August 27, 2018. Painting with a broad brush, Prop. Reg. 1.170A-1(h)(3)(i) provided a flat-out rule, applicable to both newly created and pre-existing tax credit programs, that "if a taxpayer makes a payment or transfer 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." Notwithstanding the indication in Notice 2018-54 that the proposed regulations would be limited to charities "controlled by state and local government" under the recent workaround legislation, the proposed regulations were broad in their application, providing that the amount of a charitable income tax deduction under IRC Section 170(a) for a contribution to any entity must be reduced by the amount of any state or local tax credit the taxpayer receives or expects to receive in return. Thus, the proposed regulations failed to distinguish between new legislative schemes that would allow residents to contribute to a government-run charity and obtain a tax credit in return and those longstanding programs in which states provide tax credits for contributions to charities or educational institutions.

Based on what it described as longstanding principles of cases and tax regulations, the proposed regulations were based on the belief of the Treasury Department and IRS "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)," just as in the case of any other *quid pro quo* benefit obtained by a taxpayer in return for a charitable contribution. In support of this approach, the preamble to the proposed regulations noted that compelling policy considerations reinforce this interpretation and application of Section 170 in the context, specifically stating that “[d]isregarding the value of all state benefits received or expected to be received for charitable contributions would precipitate significant revenue losses that would undermine and be inconsistent with the limitation on the deduction for state and local taxes adopted by Congress in section 164(b)(6).”

Prop. Reg. 1.170A-1(h)(3)(vi) 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 percent of the taxpayer’s payment or 15 percent of the fair market value (FMV) of the property transferred by the taxpayer. Finally, the proposed regulations clarify that if a taxpayer makes a payment or transfers property and the taxpayer receives a state or local tax deduction, as opposed to a state or local tax credit, which 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) on account of such state or local deduction. Prop. Reg. 1.170A-1(h)(3)(ii). The distinction between state or local credits and state or local deductions was made on the grounds that the benefit of a dollar-for-dollar deduction is limited by the applicable state and local marginal rates. As such, the risk of a state or local tax deduction being used to circumvent the new SALT cap is considered to be low.

Issuance of Final Regulations

The final regulations (TD 9864, 6/11/2019) that were issued on June 11, 2019, which apply to amounts paid or property transferred by a taxpayer after August 27, 2018, generally retain the amendments set forth in the proposed regulations, with certain clarifying and technical changes. As in the case of the proposed regulations, the final regulations are broad in their application, making no distinction between a contribution to a newly formed state-controlled entity created under recent legislation aimed at avoiding the SALT limitation and a contribution to an independent public charity, such as a community organization or private school, where contributions made to such organizations pursuant to longstanding programs have resulted in state or local tax credits to their donors.

The final regulations retain the general rule that 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). The following example is provided under Reg. 1.170A-1(h)(3)(vii)(A), Example 1:

> A, 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 percent of the amount of A's payment to X. Under paragraph (h)(3)(i) of this section, A's charitable contribution deduction is reduced by $700 (0.70 x $1,000). This reduction occurs regardless of whether A is able to claim the state tax credit in that year. Thus, A's charitable contribution deduction for the $1,000 payment to X may not exceed $300.

The final regulations retain the *de minimis* exception provided in the proposed regulations, whereby a state or local tax credit that doesn't exceed 15 percent of the amount of the contribution isn't treated as a *quid pro quo* benefit and, therefore, doesn't reduce the taxpayer's charitable income tax deduction. Reg. 1.170A-1(h)(3)(vi), Example 2, provides the following example:

> B, an individual, transfers a painting to Y, an entity described in section 170(c). At the time of the transfer, the painting has a fair market value of $100,000. In exchange for the painting, B receives or expects to receive a state tax credit equal to 10 percent of the fair market value of the painting. Under paragraph (h)(3)(vi) of this section, B is not required to apply the general rule of paragraph (h)(3)(i) of this section because the amount of the tax credit received or expected to be received by B does not exceed 15 percent of the fair market value of the property transferred to Y. Accordingly, the amount of B's charitable contribution deduction for the transfer of the painting is not reduced under paragraph (h)(3)(i) of this section.

The final regulations clarify that the 15 percent exception applies if "total amount of the state and local tax credits," i.e., the sum of such credits, received, or expected to be received, does not exceed 15 percent of the taxpayer's payment or 15 percent of the fair market value of the property transferred by the taxpayer. The proposed regulations looked only separately to “the amount of the state or local tax credit” in applying the 15 percent exception. Prop. Reg. 1.170A-1(h)(3)(vi).

A number of comments received in response to the proposed regulations stated that the 15 percent exception results in an unfair “cliff effect” because credits above 15 percent do not receive the benefit of this exception. The comments noted that this unfairness is most significant where credits only exceed 15 percent by a small amount. A number of commenters also suggested that an amount equal to the first 15 percent of all credits should be disregarded so that no matter what the amount of the credit, a charitable deduction would always available for at least 15% of the amount of the contribution. Commenters also noted that the proposed regulations penalize donors of smaller amounts because 15 percent of a large payment results in a much larger amount covered by the exception than 15 percent of a small payment. Ultimately, the suggestions to disregard an amount equal to 15 percent of the donor’s transfer or otherwise change the 15 percent exception was not adopted on the basis of the following rationale contained in the preamble to the final regulations:

> The 15-percent exception was designed to provide consistent treatment for state or local tax deductions and state or local tax credits that provide a benefit that is generally equivalent to a deduction. The 15-percent exception is intended to reflect the combined benefit of state and local tax deductions, that is, the combined top marginal state and local tax rates, which the Treasury Department and the IRS understand currently do not exceed 15 percent. The Treasury Department and the IRS considered tailoring this exception to the combined marginal state and local tax rates applicable for a taxpayer’s particular jurisdiction. The Treasury Department and the IRS determined that using a single rate sufficient to cover the highest existing marginal rates would avoid the complexity and burden that would arise if a taxpayer had to compute the sum of the taxpayer’s state and local marginal tax rates to determine whether the tax credit received exceeded the benefit that the taxpayer would have received as a deduction.

The final regulations retain the rule in the proposed regulations that a taxpayer generally is not required to reduce its charitable contribution deduction on account of its receipt of state or local tax *deductions* (as opposed to credits). Reg. 1.170A-1(h)(3)(ii)(A). The final regulations retain the exception to this rule in the proposed regulations for “excess state or local tax deductions.” Reg. 1.170A-1(h)(3)(ii)(B). Under this exception, the taxpayer must reduce the charitable contribution deduction if the taxpayer receives or expects to receive state or local tax deductions in excess of the taxpayer’s payment or the fair market value of property transferred by the taxpayer. Reg. 1.170A-1(h)(3)(vi), Example 3, provides the following example:

> C, an individual, makes a payment of $1,000 to Z, an entity described in section 170(c). In exchange for the payment, under state M law, C is entitled to receive a state tax deduction equal to the amount paid by C to Z. Under paragraph (h)(3)(ii)(A) of this section, C’s charitable contribution deduction under section 170(a) is not required to be reduced on account of C‘s state tax deduction for C’s payment to Z.

Finally, the final regulations retain the provision in the proposed regulations whereby the final regulations under Reg. 1.170A-1(h)(3) apply to payments made by a trust or a decedent’s estate in determining its charitable contribution deduction under Section 642(c). Reg. 1.642(c)-3(g), applicable to payments of gross income after August 27, 2018. In lieu of the charitable income tax deduction under Section 170(a), a charitable income tax deduction is available under Section 642(c) for trusts and estates if all of the requirements of that section are met, including that the amount paid is from gross income, paid pursuant to the terms of the governing instrument, and is for a purpose specified in Section 170(c). Therefore, the same *quid pro quo* rules under the final regulations apply where a trust or estate makes a charitable contribution resulting in state or local tax credit in return for the contribution.

Rejection of CCA 201105010 Holding That Charitable Deduction Isn’t Reduced by Tax Credits Received in Return

The preamble to the final regulations states that the new SALT limitation, and the resulting efforts by states and taxpayers to devise alternate means for deducting the disallowed portion of their state and local taxes, has generated increased interest in the question of whether a state or local tax credit should be treated as a return benefit – a *quid pro quo* – when received in return for making a payment or transfer to an entity described in section 170(c). It specifically states that the “Treasury Department and the IRS did not publish formal guidance on this question before the enactment of the limitation under section 164(b)(6).”

It is interesting that the preamble to the final regulations specifically notes that in CCA 201105010 (Oct. 27, 2010) (“2010 CCA”), “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.” Although 2010 CCA recognized the general principal that the value of a *quid pro quo* benefit reduces the charitable income tax deduction otherwise available, it specifically stated that “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***.” (Emphasis added.) On this basis, longstanding tax credit programs offered charitable contribution deductions, without reduction for an otherwise *quid pro quo* benefit received in the form of a state or local tax credit. While 2010 CCA isn’t legally binding precedent, the IRS has never published formal guidance to the contrary and has apparently applied the conclusion reached in 2010 CCA to such programs.

In the preamble, the “Treasury Department and the IRS acknowledge that the proposed and final regulations depart from the conclusion of the 2010 CCA in important respects.” In support of such a departure, the preamble states that the 2010 CCA failed to persuasively explain why state and local tax credits should not count as return benefits for purposes of applying the *quid pro quo* principle. Furthermore, it states that the analysis in the 2010 CCA assumed that after the taxpayer applied the state or local tax credit to reduce the taxpayer’s state or local tax liability, the taxpayer would receive a smaller deduction for state and local taxes under Section 164. The preamble also states that with the enactment of Section 164(b)(6), “that assumption no longer holds true for the vast majority of taxpayers. The changes in the tax laws reduce the number of taxpayers who will itemize deductions, and for taxpayers who itemize and have state and local tax liabilities above the new limitation, the use of the tax credit would not reduce the deduction for state and local taxes."

The preamble states that in light of the Section 164(b)(6) limitation, the Treasury Department and the IRS have specifically considered the application of the *quid pro quo* principle to state and local tax credit programs and "have determined that it is appropriate to treat the receipt or the expectation of receipt of state and local tax credits as return benefits." As a result, the final regulations reject the 2010 CCA's conclusion that the contribution deduction does not need to be reduced by the value of the state and local tax credit received or expected to be received. In reaching this conclusion, the preamble cites various legal authority for the principle that a charitable contribution deduction is not available where there the donor receives a substantial benefit in return. For example, it cites *American Bar Endowment*, 477 U.S. 105 (1986), where the Supreme Court stated that the "sine qua non of a charitable contribution is a transfer of money or property without adequate consideration," that is, without the expectation of a *quid pro quo*. In that case, the Court held that a "payment of money generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return."

The Treasury and the IRS further state in the preamble that the treatment of state and local tax benefits as a *quid pro quo* is consistent not only with the purpose of Section 170, but also with the Section 164(b)(6) limitation, stating:

> If the Treasury Department and the IRS were to allow taxpayers to claim a full charitable contribution deduction for contributions made in exchange for state tax credits, this treatment would result in significant federal tax revenue losses that would undermine the limitation on the deduction for state and local taxes in section 164(b)(6). Such an approach would enable taxpayers to characterize payments as fully deductible charitable contributions for federal income tax purposes, while using the same payments to satisfy their state tax liabilities. As a result, the final regulations reject the 2010 CCA's conclusion that the contribution deduction does not need to be reduced by the value of the

state and local tax credit received or expected to be received.

Safe Harbor to Allow Tax Deduction Under Section 164 for Payments Disallowed as Charitable Contribution Under Final Regulations

On the same date that TD 9864 was issued, the IRS issued Notice 2019-12, 2019-27 IRB (6/11/2019), in which it was announced that proposed regulations 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 regulations.

This treatment as a payment of state or local tax under Section 164 is allowed in the taxable year in which the payment is made to the extent the resulting credit is applied, consistent with applicable state or local law, to offset the individual's state or local tax liability for such taxable year or the preceding taxable year. To the extent the resulting credit is not applied to offset the individual's state or local tax liability for the taxable year of the payment or the preceding taxable year, any excess credit permitted to be carried forward may be treated as a payment of state or local tax under Section 164 in the taxable year or years for which the carryover credit is applied, consistent with applicable state or local law, to offset the individual's state or local tax liability. The safe harbor does not apply to a transfer of property.

COMMENT:

While the final regulations clearly target recently enacted state and local legislative efforts seeking to circumvent the annual $10,000 SALT limitation, their application also extends to longstanding programs across the country in which state and local tax credits have been provided for donations to certain community organizations and private schools where, with the apparent blessing 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 regulations 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.

Conclusion

Consistent with Notice 2018-54 and the proposed regulations previously issued by the IRS, and nullifying the $10,000 annual SALT limitation legislative workaround attempts by a number of states and their political subdivision, the final regulations provide that a taxpayer who makes payments or transfers property to an entity eligible to receive tax deductible contributions must reduce their charitable deduction by the amount of any state or local tax credit the taxpayer receives or expects to receive. The final regulations generally retain the amendments set forth in the proposed regulations, with certain clarifying and technical changes. Notwithstanding the indication in Notice 2018-54 that the regulations issued in this area would be limited to charities "controlled by state and local government" under recent workaround legislation, the final regulations, like the proposed regulations, are broad in their application, providing that the amount of a charitable income tax deduction under IRC Section 170(a) for a contribution to any entity must be reduced by the amount of any state or local tax credit the taxpayer receives or expects to receive in return. Thus, the final regulations fail to distinguish between new legislative schemes that would allow residents to contribute to a government-run charity and obtain a tax credit in return and those longstanding programs in which states provide tax credits for contributions to charities or educational institutions.

Nonetheless, it may be possible for taxpayers to avoid the $10,000 limitation by having real estate, subject to local real estate taxes, or other property, which produces taxable income that is subject to state (and/or local) income tax owned by one or more non-grantor trusts, subject to the multiple trust rule under Section 643(f). This is discussed in detail in Blattmachr, Shenkman & Gans, "Use Trusts to Bypass Limit on State and Local Tax Deduction," 45 Estate Planning 3 (April 2018).

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

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CITATIONS:

TD 9864; Notice 2018-54; Section 170; Reg. 1.170A-1(h)(3); CCA 201105010; *American Bar Endowment*, 477 U.S. 105 (1986); Section 164(b)(6); Notice 2019-12, 2019-27 IRB (6/11/2019); Prop. Reg. 1.170A-1(h)(3); in Blattmachr, Shenkman & Gans, "Use Trusts to Bypass Limit on State and Local Tax Deduction," 45 Estate Planning 3 (April 2018).