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Final Regulations Address Treatment of Charitable Contributions That Reduce State or Local Taxes

IRS Issues Final Regulations on Charitable Contributions that Reduce State and Local Taxes

SUMMARY

On June 11, 2019, the Department of the Treasury (the "Treasury Department") and the Internal Revenue Service (the "IRS") released final regulations (the "Final Regulations") and Notice 2019-12 addressing the availability of charitable contribution deductions when a taxpayer receives a corresponding state or local tax ("SALT") benefit.[1] The Final Regulations substantially conform to the proposed regulations that were published on August 27, 2018 in the Federal Register (the "Proposed Regulations").[2] Notice 2019-12 provides a safe harbor for an individual that has a total SALT liability that is less than the SALT Cap (as defined below) and makes a payment to a charitable entity.

The Final Regulations reduce the amount of the charitable contribution deduction available for federal tax purposes (the "federal charitable contribution deduction") in two circumstances. *First*, the federal charitable contribution deduction is reduced by an amount equal to any SALT credit that the taxpayer receives or expects to receive for the charitable contribution made, subject to a *de minimis* exception if the SALT credit is 15% or less of the amount of the donation. *Second*, the federal charitable contribution deduction is reduced (in a manner that is not entirely clear) to the extent a charitable contribution is deductible from state or local taxable income in an amount that exceeds the amount of money or fair market value of the property donated.

In addition, although the Final Regulations apply to business taxpayers, the preamble to the Final Regulations (the "Preamble") confirms that neither the Final Regulations nor Rev. Proc. 2019-12 (which

provides safe harbors for certain payments by C corporations and certain pass-through entities, discussed further below) otherwise affects the availability of deductions for ordinary and necessary business expenses incurred in carrying on a trade or business.

The Final Regulations are effective 60 days after publication in the Federal Register and apply to charitable contributions made after August 27, 2018.

BACKGROUND

The Internal Revenue Code (the "Code") generally allows individual taxpayers to deduct charitable contributions made during the taxable year, subject to certain overall limitations.[3] The Code also generally allows trusts and decedents' estates to claim deductions for charitable contributions paid during the taxable year.[4] A charitable contribution for this purpose is generally defined as a contribution or gift to or for the use of government entities or non-profit organizations with a charitable or religious purpose, but only to the extent the contribution was made without the expectation of a substantial benefit in return (the "*quid pro quo* principle").[5]

In December 2017, Congress enacted comprehensive tax reform legislation that, among other changes, limited the ability of individuals and trusts to deduct state and local taxes for federal income tax purposes (such limitation, the "SALT Cap").[6] Certain states with high SALT rates have reacted by proposing or adopting legislation aimed at mitigating the costs to taxpayers of the SALT Cap, including legislation providing for the creation of state-sponsored charitable funds.[7] Under these proposals, taxpayers would receive full or partial state or local tax credits against such taxpayers' SALT liability for contributions to such charitable funds, and the contributions are intended to be fully deductible for federal tax purposes. New York State, for example, provided for the creation of such charitable funds in its State Budget for Fiscal Year 2019 enacted in April 2018.[8]

After issuing a notice in May 2018 to taxpayers informing them that the Treasury Department and the IRS intended to propose regulations on the issue of charitable deductions,[9] the Treasury Department and the IRS on August 23, 2018 released the Proposed Regulations that would effectively have disallowed federal charitable contribution deductions for any donations that result in the taxpayer receiving SALT credits above a *de minimis* threshold.

In addition, on December 28, 2018, the Treasury Department and the IRS issued Rev. Proc. 2019-12, which provided safe harbors for certain charitable payments made by business taxpayers.[10] More specifically, Rev. Proc. 2019-12 provided that (i) if a C corporation makes a charitable payment in exchange for SALT credit, the C corporation may deduct the payment as an ordinary and necessary business expense to the extent of any SALT credit received or expected to be received and (ii) if a "specified pass-through entity" makes a charitable payment in exchange for SALT credit, such pass-through entity may similarly deduct the payment as an ordinary and necessary business expense but only to the extent of any SALT credit that

offsets non-income taxes at the state and local level imposed directly upon the pass-through entity.[11] A "specified pass-through entity" for this purpose is defined as a business entity other than a C corporation that is regarded for all federal income tax purposes as separate from its owners (i.e., not a "disregarded entity"). The entity also must operate a trade or business within the meaning of Section 162 of the Code and be subject to SALT incurred in carrying on such trade or business that is imposed directly on the entity.[12] The safe harbors apply to any charitable payments made on or after January 1, 2018.

DISCUSSION

The Final Regulations are substantively the same as the Proposed Regulations,[13] and reduce the federal charitable contribution deduction in circumstances in which certain SALT benefits are available to the taxpayer for making charitable contributions. The Preamble explains that, under the *quid pro quo* principle, a full federal deduction for charitable contributions is precluded if a taxpayer receives or expects to receive a SALT credit in return. Notably, the Preamble acknowledges that such a view is a departure from the previous administrative position of the IRS stated in Chief Counsel Advice 201105010 (the "CCA"), where the IRS had concluded that SALT credits received or expected to be received do not reduce the federal charitable contribution deduction amount because SALT credits should not count as return benefits for purposes of applying the *quid pro quo* principle.[14] The Preamble states that the CCA failed to adequately explain why the *quid pro quo* principle does not apply to SALT credits, and that the analysis of the CCA was based on assumptions that are no longer valid in light of the enactment of the SALT Cap. Thus, the Preamble provides that the Final Regulations reject the conclusion of the CCA.

A. OVERVIEW OF THE FINAL REGULATIONS

1. Charitable Contributions Giving Rise to SALT Credits

The Final Regulations reduce the amount of federal charitable contribution deductions if the taxpayer receives or expects to receive a SALT credit "in consideration" for the donation, subject to the *de minimis* exception discussed below.[15] Under existing Treasury Regulations, a taxpayer is treated as making a donation "in consideration" for goods or services if the taxpayer receives or expects to receive such goods and services.[16] The Final Regulations provide that the SALT credit does not need to be provided by the donee organization in order to meet the "in consideration" requirement.

Under the *de minimis* exception, there is no reduction of the federal charitable contribution deduction amount if the amount of SALT credit does not exceed 15% (such percentage, the "De Minimis Threshold") of the amount of money or fair market value of the property donated.[17] According to the Preamble, the *de minimis* exception intends to provide consistent treatment with respect to states that only provide state and local level deductions (rather than credits) for charitable contributions, discussed below in Part A.2. The IRS selected 15% as the De Minimis Threshold because the highest combined marginal SALT rate (which would be the value of a deduction against state and local taxable income) in the United States currently does not exceed 15%.

Once the De Minimis Threshold is exceeded, however, the amount of the federal charitable contribution deduction is reduced by the entire amount of SALT credit available that corresponds to the donation (the "cliff"). In other words, the federal charitable contribution deduction is reduced dollar-for-dollar for the entire amount of SALT credits available.[18]

2. Charitable Contributions Giving Rise to SALT Deductions

The Final Regulations do not reduce the federal charitable deduction due to the availability of a dollar-for-dollar state and local deduction for charitable contributions. The Preamble explains that, because the benefit of a dollar-for-dollar state and local level deduction is limited to the taxpayer's state and local marginal tax rate, the risk of state and local level deductions being used to circumvent the SALT Cap is comparatively low. The Preamble also states that allowing state and local deductions for charitable contributions would avoid additional administrative and taxpayer burden. Thus, for example, a charitable contribution of $1,000 that results in $1,000 deducted against state and local taxable income would not reduce the amount of the federal charitable contribution deduction.[19]

However, if the amount deducted against state and local taxable income exceeds the amount of money or the fair market value of the property donated, then the federal charitable contribution deduction is reduced under the Final Regulations.[20] Although the preamble to the Proposed Regulations had requested comments on how to determine the amount of such reduction, the Final Regulations do not make any clarifications. The Preamble refers to "excess state and local tax deductions," which could be read to mean that the reduction only applies to SALT deduction amounts above the fair market value of the property donated, but the Final Regulations clearly provide for a "cliff" that applies to SALT credits exceeding the De Minimis Threshold, discussed above, suggesting that SALT deductions above the value of the property donated could be subject to a similar "cliff" effect.

3. Federal Charitable Contribution Deductions by Trusts and Decedents' Estates

If a trust or a decedent's estate makes a charitable contribution and receives or expects to receive a SALT benefit in consideration for such payment, then the same rules applicable to other taxpayers in Sections 1 and 2 above are also applicable to the trust or decedent's estate to reduce the federal charitable contribution deduction otherwise available.[21]

B. APPLICATION OF THE FINAL REGULATIONS TO BUSINESS TAXPAYERS

The Preamble observes that a taxpayer engaged in a trade or business may, in some circumstances, be permitted to deduct amounts paid to charitable organizations as an ordinary and necessary business expense.[22] Moreover, the Preamble states that a few commenters expressed the view that the Proposed Regulations escalate the disparate treatment of charitable contributions by individual wage earners as compared to similar contributions by pass-through entities and their members who are individuals because the SALT Cap does not apply to entity-level state and local taxes paid or accrued in carrying on a business. The Preamble notes, however, that the Proposed and Final Regulations apply to charitable contributions

by a business taxpayer, and thus "a business taxpayer, like an individual taxpayer, must reduce the charitable contribution deduction by the amount of any return benefit received or expected to be received."[23]

Notwithstanding the reductions to the federal charitable contribution deduction, Rev. Proc. 2019-12 (discussed above) permits business taxpayers such as C corporations and certain pass-through entities to treat charitable contributions for which SALT credits are available as deductible ordinary and necessary business expense under Section 162 of the Code, to the extent of the amount of such SALT credits (but only non-income SALT credits, in the case of pass-through entities). In addition, the Preamble explains that "[n]either the final regulations nor the safe harbors in the revenue procedure otherwise affect the availability of a business expense deduction under section 162 for payments that are ordinary and necessary expenses incurred in carrying on a trade or business."[24]

C. TREATMENT OF CONSERVATION EASEMENT CONTRIBUTIONS

The Preamble also discusses comments received from conservation easement donors, land trusts and government entities involved in conservation easement contributions. *First*, while Treasury Department and the IRS recognized that "conservation easements provide unique and perpetual benefits that are accorded favorable tax treatment by state governments as well as by Congress," the Preamble explains that the Final Regulations do not provide any special exceptions for conservation easement contributions because there is no authority under Section 170 of the Code to void the general applicability of the *quid pro quo* principle and charitable intent doctrine. *Second*, another group of commenters stated that determining the value of a conservation easement may be difficult for both donors and donees (*e.g.*, where a donor receives a tax credit for every year the donor holds the easement property), and thus that it may be difficult to comply with the requirement that the federal charitable contribution deduction be reduced by an amount equal to the maximum credit allowable that corresponds to the contribution.[25] The Preamble states that if there is no clear maximum credit allowable, taxpayers may reduce their federal charitable contribution deduction using a good-faith estimate of the value of the credit.[26] *Third*, some commenters noted that conservation easement donors who sell their credit should get basis in the credit equal to the amount of the reduction in the federal charitable contribution deduction. The Preamble states that although the basis issue is beyond the scope of the Final Regulations, the Treasury Department and the IRS intend to consider the issue for further guidance.[27]

D. NOTICE 2019-12

In addition to the Final Regulations, the IRS also issued a notice of intent to propose regulations providing a safe harbor under Section 164 of the Code to individual taxpayers. More specifically, an individual who (i) itemizes deductions, (ii) makes a charitable contribution (of cash only) in return for SALT credits and (iii) has total SALT liability below the SALT Cap (before taking into account SALT credits in return for the charitable payment) may treat such charitable payment as a payment of state and local taxes so that the payment can be deducted against federal income. The Preamble states that the Treasury Department and

the IRS anticipate issuing the relevant proposed regulations shortly after the issuance of the Final Regulations.[28] The safe harbor applies to all charitable payments after August 27, 2018, and taxpayers may rely on the Notice until the issuance of the relevant proposed regulations.

E. EFFECTIVE DATE AND ADDITIONAL CONSIDERATIONS

The Final Regulations become effective 60 days after publication in the Federal Register, and apply to all charitable contributions made after August 27, 2018.[29]

In the Preamble, the Treasury Department and the IRS state that they will continue to consider:

- the application of the rules under sections 61, 164, 1001, and 1012 to the receipt, expectation of receipt, or use of tax credits;
- comments received involving the effect of the Final Regulations on various business entities and will provide additional guidance as needed;
- new comments on how taxpayers may decline state or local tax credits in order to obtain greater federal charitable contribution deductions; and
- other tax consequences of treating tax credits as *quid pro quo* benefits.

Questions regarding the Final Regulations or Notice 2019-12 may be directed to any member of the Tax Group.

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ENDNOTES

1 Treasury Decision 9864 (June 11, 2019).

2 REG-112176-18 (published in the Federal Register on August 27, 2018, at 83 Fed. Reg. 43563).

3 Section 170(a) & (b).

4 Section 642(c); Treas. Reg. § 1.642(c)-1.

5 Section 170(c); *see* United States v. American Bar Endowment, 477 U.S. 105, 116 ("A payment of money generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return.").

6 P.L. 115-97 (2017). For more information on federal tax reform's impact on individuals, *see* the Sullivan & Cromwell publication, dated January 8, 2018, titled "U.S. Tax Reform: Individual Taxation," *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_U.S._Tax_Reform_Individual_Taxation.pdf.

7 For more information on reactions by states to federal tax reform's limitation on state and local tax deductions, *see* the Sullivan & Cromwell publication, dated March 5, 2018, titled "Tax Reform and State and Local Taxation: Recent State Tax Proposals Relating to the Limitation on State and Local Tax Deductions Enacted by Federal Tax Reform," *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Tax_Reform_and_State_and_Local_Taxation_03_05_18.pdf.

8 New York State Budget for Fiscal Year 2019, S.7509-C; A.9509-C. *See also* the Sullivan & Cromwell publication, dated April 13, 2018, titled "New York State Tax: Recent Developments in New York State Tax Law Including Tax Provisions in the Recently Enacted Budget," *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_New_York_State_Tax_04_13_2018.pdf.

9 Notice 2018-54 (May 23, 2018).

10 2019-04 I.R.B. 401.

11 Rev. Proc. 2019-12, Sections 3 & 4.

12 Rev. Proc. 2019-12, Section 4.02.

13 The Preamble states that approximately 70% of commenters recommended that the Treasury Department and the IRS finalize the Proposed Regulations without change.

14 *See* IRS Chief Counsel Advice Memorandum 201105010 (October 27, 2010).

15 Treas. Reg. § 1.170A-1(h)(3)(i).

16 Treas. Reg. § 1.170A-1(h)(3)(iii); Treas. Reg. § 1.170A-13(f)(6).

17 Treas. Reg. § 1.170A-1(h)(3)(vi).

18 *See* Example 1, Treas. Reg. § 1.170A-1(h)(3)(vii).

19 Treas. Reg. § 1.170A-1(h)(2)(ii)(A); Example 3, Prop. Treas. Reg. § 1.170A-1(h)(3)(vii).

20 Treas. Reg. § 1.170A-1(h)(2)(ii)(B).

21 Treas. Reg. § 1.642(c)-3(g).

22 Preamble, p.27, *citing to* Marquis v. Comm'r, 49 T.C. 695 (1968) (taxpayer's cash payments to clients that were charitable entities furthered her travel agency business and were therefore not subject to the limitations of section 170).

23 Preamble, p.28.

24 Preamble, p.29.

ENDNOTES (CONTINUED)

[25] Treas. Reg. § 1.170A-1(h)(3)(iv).

[26] Preamble, p.26.

[27] *Id*.

[28] Preamble, p.46.

[29] Treas. Reg. § 1.170A-1(h)(3)(viii); Treas. Reg. § 1.642(c)-3(g)(1).

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