

August 24, 2018

Tax Reform and State and Local Taxation

IRS Issues Proposed Regulations on Charitable Contributions and State and Local Tax Credits and Deductions

SUMMARY

On August 23, 2018, the Department of the Treasury (the “Treasury Department”) and the Internal Revenue Service (the “IRS”) issued proposed regulations (the “Proposed Regulations”) addressing the availability of charitable contribution deductions when a taxpayer receives a corresponding state or local tax (“SALT”) benefit, either in the form of tax credits or deductions.¹ The Proposed Regulations were issued in response to attempts by various state and local governments, such as New York and California, to allow taxpayers to circumvent the \$10,000 cap on SALT deductions instituted by the recent federal tax reform by granting a significant credit against SALT liability for contributions to specified charities. Taxpayers would effectively substitute charitable contributions for SALT payments and claim a federal charitable contribution deduction, which is not subject to the \$10,000 cap.

The Proposed Regulations would 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 would be 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 would be reduced (in a manner yet to be determined) 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.

If finalized, the Proposed Regulations would apply to all charitable contributions made after August 27, 2018. However, the preamble to the Proposed Regulations indicates that the IRS believes the Proposed

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Regulations to be a statement of current law, so it is possible that charitable contributions made on or before August 27, 2018, could still be challenged by the IRS.

BACKGROUND

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”).² 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.³ Under such 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 2018.⁴

On May 23, 2018, the Treasury Department and the IRS issued Notice 2018-54 (the “Notice”), informing taxpayers that the Treasury Department and the IRS intended to propose regulations addressing the federal income tax treatment of payments made by taxpayers to charitable funds controlled by state and local governments (or other state-specified transferees) for which taxpayers can receive a credit against their state and local taxes. While not reaching a conclusion, the Notice warned taxpayers that “[d]espite these state efforts to circumvent the new statutory limitation on state and local tax deductions, taxpayers should be mindful that federal law controls the proper characterization of payments for federal income tax purposes.”

The Internal Revenue Code (the “Code”) generally allows individual taxpayers to take deductions for any charitable contributions paid during the taxable year, subject to certain overall limitations.⁵ The Code also generally allows trusts and decedents’ estates to take unlimited deductions for charitable contributions paid during the taxable year.⁶ Charitable contributions are 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 property, service or other benefit or consideration in return.⁷

DISCUSSION

The Proposed Regulations would reduce the federal charitable contribution deduction where there is a SALT benefit to the taxpayer for making charitable contributions. The preamble explains that, under the principle that a charitable contribution deduction is allowed only to the extent that the contribution was made without the expectation of a *quid pro quo*, a full federal deduction for charitable contributions may be precluded if a taxpayer receives or expects to receive a SALT credit in return for a donation. The preamble acknowledges that, in prior Chief Counsel Advice, the IRS had concluded that a charitable

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deduction would be available in similar circumstances.⁸ The preamble further explains, however, that while prior to the federal tax reform there was little difference between charitable contributions and SALT payments, since both were generally deductible, after tax reform that is no longer the case. Accordingly, the Treasury Department and the IRS believe it is appropriate to revisit the question of whether a charitable deduction should be permitted.

A. REDUCTION OF FEDERAL CHARITABLE CONTRIBUTION DEDUCTION FOR STATE AND LOCAL TAX CREDITS

The Proposed Regulations would reduce the amount of federal charitable contribution deduction if the taxpayer receives or expects to receive a SALT credit “in consideration” for the donation, subject to the *de minimis* exception discussed below.⁹ 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.¹⁰ The Proposed Regulations would provide that the SALT credit would not need to be provided by the donee organization in order to meet the “in consideration” requirement.

Under the *de minimis* exception, there would be 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.¹¹ According to the preamble, the *de minimis* exception is intended 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 Section B. 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 federal charitable contribution deduction would be reduced by the entire amount of SALT credit available that corresponds to the donation. In other words, the federal charitable contribution deduction would be reduced dollar-for-dollar for the amount of SALT credits available.¹²

B. REDUCTION OF FEDERAL CHARITABLE CONTRIBUTION DEDUCTION FOR CERTAIN STATE AND LOCAL LEVEL CHARITABLE CONTRIBUTION DEDUCTIONS

The Proposed Regulations would not reduce the federal charitable deduction merely 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. 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.¹³

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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 would be reduced under the Proposed Regulations.¹⁴ The Proposed Regulations do not provide how the amount of reduction of federal charitable contribution deduction should be determined if there is such an excess of state and local deduction over the amount of the donation, and the IRS has requested comments on the issue.

C. 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 B and C above are also applicable to the trust or decedent's estate to reduce the federal charitable contribution deduction otherwise available.¹⁵

D. EFFECTIVE DATE AND COMMENT PERIOD

If finalized in their current form, the Proposed Regulations would apply to all charitable contributions made after August 27, 2018, regardless of whether the state law providing for such SALT benefits existed prior to the federal tax reform in December 2017.¹⁶

In addition to the question of how to determine the amount of federal charitable contribution deduction reduced for state and local deductions exceeding the amount donated, discussed above in Section B, the Treasury Department and the IRS have requested comments on various other issues, including:

- whether there should be recognition of gain or loss when property is transferred in consideration for SALT credits above the De Minimis Threshold;
- the determination of the basis of a transferable tax credit that a taxpayer sells or exchanges;
- procedures by which a taxpayer may establish that the taxpayer declined a SALT credit and thus should not be subject to a reduced federal charitable contribution deduction;
- substantiation and reporting requirements for donors and donees with respect to donations made for SALT benefits;
- whether and in what manner regulations should address other forms of SALT benefits such as exclusions from gross income; and
- alternative regulatory approaches to prevent circumvention of the SALT Cap.

Written and electronic comments to the Proposed Regulations must be received by the IRS by the date that is 45 days after the publication of the Proposed Regulations in the Federal Register. The Proposed Regulations are scheduled to be published in the Federal Register on August 27, 2018. Persons wishing

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to present oral comments at a public hearing on the Proposed Regulations scheduled for November 5, 2018 must submit an outline of the topics to be discussed by the same date on which written and electronic comments are due.

Questions regarding the Proposed Regulations may be directed to any member of the Tax Group.

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ENDNOTES

- 1 REG-112176-18.
- 2 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.
- 3 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.
- 4 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.
- 5 Section 170(a) & (b).
- 6 Section 642(c); Treas. Reg. § 1.642(c)-1.
- 7 Section 170(c).
- 8 See, e.g., IRS Chief Counsel Advice Memorandum 201105010 (October 27, 2010).
- 9 Prop. Treas. Reg. § 1.170A-1(h)(3)(i).
- 10 Prop. Treas. Reg. § 1.170A-1(h)(3)(iii); Treas. Reg. § 1.170A-13(f)(6).
- 11 Prop. Treas. Reg. § 1.170A-1(h)(3)(vi).
- 12 See Example 1, Prop. Treas. Reg. § 1.170A-1(h)(3)(vii).
- 13 Prop. Treas. Reg. § 1.170A-1(h)(2)(ii)(A); Example 3, Prop. Treas. Reg. § 1.170A-1(h)(3)(vii).
- 14 Prop. Treas. Reg. § 1.170A-1(h)(2)(ii)(B).
- 15 Prop. Treas. Reg. § 1.642(c)-3(g).
- 16 Prop. Treas. Reg. § 1.170A-1(h)(3)(viii); Prop. Treas. Reg. § 1.642(c)-3(g)(1).

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CONTACTS

New York

Ronald E. Creamer Jr.	+1-212-558-4665	creamerr@sullcrom.com
David P. Hariton	+1-212-558-4248	haritond@sullcrom.com
Jeffrey D. Hochberg	+1-212-558-3266	hochbergj@sullcrom.com
Donald L. Korb	+1-212-558-4822	korbd@sullcrom.com
Andrew S. Mason	+1-212-558-3759	masona@sullcrom.com
Andrew P. Solomon	+1-212-558-3783	solomona@sullcrom.com
David C. Spitzer	+1-212-558-4376	spitzerd@sullcrom.com
Davis J. Wang	+1-212-558-3113	wangd@sullcrom.com
S. Eric Wang	+1-212-558-3328	wangs@sullcrom.com
Isaac J. Wheeler	+1-212-558-7863	wheeleri@sullcrom.com
M. John Jo	+1-212-558-3202	jojohn@sullcrom.com

Washington, D.C.

Donald L. Korb	+1-202-956-7675	korbd@sullcrom.com
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London

Ronald E. Creamer Jr.	+44-20-7959-8525	creamerr@sullcrom.com
S. Eric Wang	+44-20-7959-8411	wangs@sullcrom.com
