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IRS Finalizes Regulations Disallowing Workarounds for State and Local Taxes

Ballard Spahr LLP
Article By
Wendi L. Kotzen
Christopher A. Jones
Ballard Spahr LLP
CyberAdvisor

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The IRS recently published Final Regulations and Notice 2019-12 largely blocking state efforts to circumvent limitations on deductions for state and local taxes. (See our alert on the Proposed Regulations, issued in August 2018.) Several states enacted programs that would have allowed taxpayers in those states effectively to avoid the new $10,000 cap on deductions by individuals for state and local taxes. The Final Regulations attempt to block the state workarounds.

The Final Regulations apply to all charitable contributions made after August 27, 2018.

Tax Cuts and Jobs Act – Limitation on Deductions for State and Local Taxes

Effective for tax years beginning after December 31, 2017, for individuals who itemize deductions for federal income tax purposes, the deduction for state and local taxes is limited to $10,000. This limitation disproportionately affects individuals who live in high-tax states, including California, Maryland, Minnesota, New Jersey, and New York.

There is no similar cap on the allowable deduction for charitable contributions by individuals who itemize their deductions. As a result, many states enacted, or took

steps toward enacting, legislation to allow taxpayers to make contributions to a charitable fund established by a municipality and receive a credit against state taxes for the contribution. Prior to the Tax Cuts and Jobs Act (TCJA), many states already had programs whereby taxpayers could reduce state taxes by making contributions to specific charities (frequently educational institutions or programs) in exchange for credits against state taxes or deductions against state income.

Proposed Regulations – August 2018

The IRS announced in May 2018 that it intended to block state efforts to institute workarounds for the limitation on the deduction for state and local taxes.

As described in more detail in our aforementioned August 2018 alert, the Proposed Regulations provided the following rules for contributions made after August 27, 2018:

- A charitable deduction only will be allowed to the extent a contribution to a charity exceeds the amount of state tax credit generated by the contribution.
- The limitation applies only to programs whereby—in exchange for a charitable contribution—a taxpayer receives dollar-for-dollar credits against the tax, not programs that allow a deduction against income.
- There is a carve-out from the limitation for credit programs where the credit is 15% or less of the contributed amount.

The Final Regulations – Disallowance of a Federal Deduction for the Contribution

The Final Regulations generally retain the approach set forth by the Proposed Regulations. Under long-standing federal law, a taxpayer can deduct contributions to charity, but a deduction is not permitted if the contributor receives something of value (*i.e.*, a *quid pro quo*) in exchange. Notwithstanding the IRS's longtime policy that a reduction in state or local tax liability resulting from a contribution does not constitute such a *quid pro quo*, the Final Regulations represent a departure from this long-standing position.

Under the Final Regulations, the federal charitable contribution deduction is reduced by the amount of any state or local tax credit that the taxpayer receives in return for the contribution. For example, under New Jersey's law enacted in response to the TJCA, a taxpayer would receive a credit equal to 90% of the amount contributed to a municipal charity. If a taxpayer in New Jersey contributes $20,000 to such a charity, he or she would obtain an $18,000 state tax credit. Under the new rules, a taxpayer who itemizes deductions must reduce the $20,000 federal charitable contribution deduction by the $18,000 state tax credit, leaving a federal charitable contribution deduction of $2,000. Additionally, he or she can deduct only $10,000 as state and local taxes, meaning a large portion of the deduction is lost.

The Final Regulations retain the exception for state and/or local tax credit programs with a credit of 15% or less of the contributed amount. Therefore, if the taxpayer received a credit of $3,000 or less for a $20,000 contribution (instead of the $18,000 credit that would be available under New Jersey's law), he or she would not be

required to reduce his or her federal charitable contribution deduction.

Additionally, the Final Regulations retain the exemption for state and local tax *deductions* provided in exchange for charitable contributions. Thus, if the taxpayer in the above example received only a state tax *deduction* of $20,000 for the contribution of $20,000, he or she would not be required to reduce his or her federal charitable contribution deduction. The IRS explained that deductions were unlikely to be used as workarounds because the maximum benefit to taxpayers would be their marginal state and local rate.

However, the Final Regulations (like the Proposed Regulations) also provide that the federal charitable contribution deduction will be reduced in the case of "excess state and local tax deductions"—*i.e.*, when the state and local tax deduction exceeds the amount contributed by the taxpayer. No methodology is provided for determining how much the deduction is reduced in the event of excess state and local tax deductions.

Applicability to Business Taxpayers

In December 2018, the IRS published Revenue Procedure 2019-12, explaining that (1) C corporations engaged in a trade or business may deduct charitable contributions made in exchange for state or local tax credits as ordinary and necessary business deductions; and (2) pass-through entities that are engaged in a trade or business and subject to state and local taxes imposed at the *entity* level may deduct charitable contributions made in exchange for state and local credits against *non-income taxes* as ordinary and necessary business deductions. Nothing in the Final Regulations affects the ability of business taxpayers to deduct contributions as ordinary and necessary business deductions within the parameters of Revenue Procedure 2019-12. Therefore, it remains possible for business taxpayers to deduct the full amount of charitable contributions in some circumstances because, as the IRS stated in Rev. Proc. 2019-12, such a payment directly benefits the business by reducing the amount of the state and local taxes the business otherwise would have to pay.

Notice 2019-12 – Safe Harbor

Finally, in Notice 2019-12, the IRS announced that it expects to publish additional regulations shortly to provide a safe harbor for taxpayers who itemize deductions and who (1) make a cash charitable contribution in exchange for state and local tax credits, and (2) have total state and local tax liability (before application of any credits received for a charitable contribution) less than $10,000. Such taxpayers may treat the payment as a payment of state and local taxes, which would be deductible against federal income. As is true of the Final Regulations, the safe harbor in Notice 2019-12 is effective for all contributions made after August 27, 2018, and taxpayers can rely on Notice 2019-12 pending the issuance of regulations establishing the safe harbor. The Treasury Department and the IRS are accepting comments by July 11, 2019, on the safe harbor described in the Notice.

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