

**MEMO: Background on the IRS draft regulations regarding contributions to charitable reserve funds**

To: Interested Parties

From: Amy R. Paulin, Member of the New York State Assembly for the 88th District

September 17, 2018

---

In response to the *Federal Tax Cuts and Jobs Act of 2017* (TCJA), the State of New York enacted legislation as part of its FY2019 Budget that authorizes counties, local governments, and school districts to establish a charitable gifts reserve fund that may be used to defray some of the costs related to public education, healthcare, or other public service provided by that entity. At the same time, New York also enacted legislation which allows counties, local governments, and public school districts the option to authorize, by means of resolution, a real property tax credit of up to 95% of the amount of a property owner's monetary contribution(s) to an established charitable reserve fund during the "associated credit year" as defined under the New York Real Property Tax Law.

It was hoped that individual taxpayers would be incentivized to contribute generously to these charitable funds out of the expectation that the pairing of an increased charitable deduction at the federal level combined with a real property tax credit at the local level might offset the effects of the new \$10,000 cap on state and local tax (SALT) deductions imposed by TCJA. This would provide some measure of relief to taxpayers who would be hardest hit by the cap on SALT deductions, particularly in localities with high school taxes and/or county and municipal property taxes. This would also aid school districts and local governments in their mission to provide high-quality public education or high-quality public services to the residents of their district.

In addition to New York, the states of Connecticut and New Jersey passed similar laws allowing for the establishment of county, municipality, or school district charitable funds.

This tax credit construction whereby a cash contribution to a recognized charity, a publicly established fund, or some public-private partnership would be matched on a dollar-to-dollar basis with a tax credit that would reduce overall state or local tax liability up to a fixed percentage of the contribution, is currently in widespread use.

- There are over 70 active programs across 24 states which specifically rely on tax credits granted to individuals who make cash donations to various entities. These programs pre-date the passage of TCJA.
- These include seven where the value of the tax credit may be as high as 100% of the value of the contribution.
- These also include arrangements whereby the state created an incentive for individuals to make cash donations to scholarship granting organizations (SGOs), nonprofits that provide private school scholarships to financially needy students, by issuing tax credits up to a percentage of the contribution.
  - These tax credits to incentivize contributions that increase access to private school education are current law in Alabama, Illinois, Indiana, Iowa, Louisiana, Montana, Oklahoma, Rhode Island, South Carolina, and Virginia.

On August 23, 2018, the Internal Revenue Service (IRS) issued proposed regulations that provide rules on the availability of federal charitable contribution deductions when the taxpayer receives or expects to receive a corresponding state or local tax credit. Specifically, the proposed regulations conclude that a taxpayer who makes a contribution to a charitable reserve fund and subsequently receives a state or local tax credit that exceeds 15 percent of the contribution must reduce his or her charitable deduction by the amount of any tax credit he or she received at the state or local level.

However, this has not been the standard to which the IRS has previously held the over 70 tax credit programs that pre-dated TJCA. Within the text of the draft regulation, the IRS acknowledges a concern that has been raised by states and private school associations about whether this new standard for charitable contributions incentivized by a tax credit would also be applied to those existing tax credit programs that pre-date the TCJA, and expressly references contribution to SGOs. As a result, the advocacy organizations that promote these scholarship programs have already made public statements that they intend to challenge this portion of the regulation.

On September 5, 2018, the IRS took the additional step of issuing IR 2018-175, which purports to clarify the impact of the proposed regulations by stating that business taxpayers who make business-related payments to charities or government entities that similarly are rewarded with a tax credit on the business's state or local taxes may continue deducting those contributions as business expenses without reducing their deductions by the amount of any tax credit received at the state or local level. Neither IR 2018-175 nor the supporting FAQ articulate a principle whereby contributions made by businesses that are incentivized by state or local tax credits should have their deductibility preserved, while contributions by individuals that are incentivized by state or local tax credits should not.

Furthermore, U.S. Treasury Secretary Steven T. Mnuchin also released a statement on September 5, 2018, specifically citing "business-related donations to school choice programs" as one of the programs involving business contributions to a charity incentivized by a state or local tax credit whose deductibility at the federal level that was to be preserved. His statement went no further than that, and offered no rationale as to why business contributions to charitable private education funds ought to be treated differently than individual contributions to charitable public education funds.

Suffice it to say, there is substantial confusion, doubt, and skepticism regarding the consistency of the legal rationale and how it would be applied should the final regulations issued by the IRS on this topic closely resemble the proposed regulations. Should the proposed regulations become final, deductibility would be preserved for business contributions but not individual contributions. It would be preserved for contributions to private school education, but not charitable funds to enhance public school education. It might be preserved for existing programs to incentivize contributions to aid the construction of public roads in Arkansas, but not for new programs to aid local public works in New York.

A number of tax law experts believe that the proposed regulations provide insufficient clarity on many topics or the underlying legal rationale for many of the distinctions drawn between deductions for individuals compared to deductions for businesses, and contributions to support public education compared to contributions to support private education, among other issues. This opens the IRS up to the charge that its interpretation of federal tax law, as currently outlined in the proposed regulations, is arbitrary and capricious and therefore invalid.