



# **IRS Proposed Regulations on Contributions in Exchange for State and Local Tax (SALT) Credits**

## **Setting the Battlefield for a Successful Regulatory Challenge**

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# Introduction

# Overview

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- The Trump Administration has proposed rules that would deny most individual taxpayers a federal income tax deduction for contributions to state and municipal charitable funds in exchange for SALT credits.
- These proposed rules bear several of the hallmarks of other IRS rules that have recently been invalidated by the federal courts:
  - Altera and Good Fortune Shipping.
- **These proposed rules are highly vulnerable to a successful “pre-enforcement” regulatory challenge by affected parties in the federal courts, so long as the battlefield is adequately set for such a challenge.**

# Historical Federal Treatment of SALT

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- Historically, state and local taxes were fully deductible against regular federal income tax for those taxpayers who did not claim the standard deduction.
  - For AMT purposes, however, the SALT deduction was limited (unlike the charitable contribution deduction).
  - Around the country, state and local governments have long awarded SALT credits in exchange for contributions.
    - Certain states historically touted these regimes as workarounds for the AMT SALT cap.

# Historical Federal Tax Treatment of SALT

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- The IRS has long taken the position (both in its guidance and in litigation) and the courts have long agreed that SALT credits and other state tax benefits received in exchange for contributions are not items of value for federal tax purposes (i.e., tax nothings).
- The IRS Office of Chief Counsel has issued several pieces of advice stating that a charitable contribution deduction should not be reduced by the amount of a state or local tax benefit received.
  - While this advice is arguably not “binding” on the IRS, it does establish the agency’s historic position, which is an important element of a future regulatory challenge.

# “Tax Reform” Changes to the SALT Deduction

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- The SALT deduction is now capped at \$10,000.
- This change was accomplished by amending 26 U.S.C. § 164.
- No relevant changes were made to the provisions governing charitable contributions (26 U.S.C. § 170), including contributions to states and municipalities.
- Certain states and municipalities with existing SALT credit regimes then began touting them as workarounds for the new SALT cap.
- Other states (like New York) have established such regimes in light of the SALT cap, and have empowered municipalities to follow suit.

# The Trump Administration Responds

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- **January 11, 2018:**
  - Treasury Secretary Mnuchin called efforts by states to limit the scaling back of state and local tax deductions "ridiculous."
- **June 11, 2018:**
  - IRS issues Notice 2018-54, stating that it will issue guidance in response to those states that have enacted (or were considering) new SALT credit regimes.
- **August 27, 2018:**
  - Treasury and the IRS publish proposed regulations in the Federal Register.
- **September 5, 2018:**
  - Treasury and the IRS "clarify" the proposed regulations.



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## The Proposed Regulations

# The Proposed Regulations: In Brief

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- Reverse the IRS's position that SALT benefits are not items of value for purposes of claiming a charitable contribution deduction, but with arbitrary exceptions and limitations:
  - Not applicable to SALT deductions that do not exceed 100 percent of the contribution.
  - Not applicable to SALT credits that do not exceed 15 percent of the contribution.
- If finalized, the Proposed Regulations will likely be effective **retroactive to August 27, 2018.**
- Comments are due by **October 11, 2018,** with a public hearing on **November 5, 2018.**

# The Proposed Regulations: Application

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- A contributes \$100X to a municipal charitable fund, which entitles A to \$15X in municipal property tax credits.
  - A is entitled to claim a \$100X charitable contribution deduction, because the \$15X is “de minimis” (no matter how great).
- A contributes \$100X to a municipal charitable fund, which entitles A to \$16X in municipal property tax credits.
  - A is entitled to only claim a \$84X charitable contribution deduction.
- A contributes \$100X to a state charitable fund, which entitles A to \$85X in state income tax credits.
  - A is entitled to only claim a \$15X charitable contribution deduction.

# The Proposed Regulations: Application

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- A contributes \$10,000 to a charitable organization, and receives tickets to a charity gala valued at \$1,500.
  - A is only entitled to claim a \$8,500 charitable contribution deduction.
- A contributes \$10,000 to a state's school choice fund, and receives \$1,500 in state tax credits.
  - A is entitled to claim a full \$10,000 charitable contribution deduction.



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IRS News Release IR-2018-178

# IRS News Release IR-2018-178

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- The IRS “clarifies” that “[b]usiness taxpayers who make business-related payments to charities or government entities for which the taxpayers receive state or local tax credits can generally deduct the payments as business expenses.”
- Echoed in a press release issued by Treasury Secretary Mnuchin:
  - *“The IRS clarification makes clear that the longstanding rule allowing businesses to deduct payments to charities as business expenses remains unchanged under the Tax Cuts and Jobs Act. The recent proposed rule concerning the cap on state and local tax deductions has no impact on federal tax benefits for business-related donations to school choice programs.”*

# IR-2018-178: What Does This Mean?

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- The IRS's "clarification" takes the position that tax credits are items of value for purposes of a charitable contribution deduction, but are not items of value for purposes of a business expense deduction.
- A, a wage earner, contributes \$100X to a state charitable fund, which entitles A to \$85X in state income tax credits.
  - A is entitled to only claim a \$15X charitable contribution deduction.
- B, self employed, contributes \$100X to a state charitable fund, which entitles B to \$85X in state income tax credits.
  - B is entitled to claim a full \$100X business expense deduction.
- What about businesses that get state tax benefits/credits in other contexts?



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## Setting the Battlefield for a Successful Regulatory Challenge

# Regulatory Challenges Under the Administrative Procedure Act (APA)

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- A court must set aside any regulations that are contrary to statute, as well as any regulations that are arbitrary and capricious.
- The APA provides the framework for regulatory challenges, and the “administrative record” provides the basis for the court’s review.
- The administrative record typically includes the preambles to the proposed and final regulations, comments from interested parties, and transcripts of hearings before the agencies.
- Little opportunity to supplement the record during administrative litigation—the record before the court is the same as the information before the agency at the time of the rulemaking.

# The Importance of Comments

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- Given the limited scope of judicial review, comments take center stage in validity challenges.
- Those comments are an opportunity to articulate concerns and to force the agency to respond.
- An agency's failure to respond to all pertinent comments is in and of itself a basis to invalidate a regulation.

# Moving Forward

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- The Coalition Process
- Comments and Testimony
- Pre-Enforcement Litigation
- Timing and Other Considerations
- Questions?



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