

## **Into the Weeds on Treasury's Rule To Block SALT Cap Workarounds**

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In this article, Buschman discusses Treasury's proposed rule to block the Tax Cuts and Jobs Act state and local tax deduction cap workarounds, which created large federal tax costs for participants in state tax credits like Georgia's scholarship and rural hospital credits. This article examines how the final rule avoids this outcome.

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As those familiar with the Tax Cuts and Jobs Act know, federal tax law now limits the amount of state and local taxes that can be included in itemized deductions to \$10,000 per return. For taxpayers in most states who found their SALT deduction limited under the new law, tax rate cuts, higher standard deductions, and other changes offset the cost of losing part of this itemized deduction. But in several high-tax states, lawmakers immediately set about enacting workarounds to the SALT deduction cap by creating state income tax credit programs modelled after established programs like

Georgia's scholarship and rural hospital tax credits.

Georgia's programs give state taxpayers a dollar-for-dollar income tax credit for donations to private charitable organizations that provide scholarships to private school students or fund rural hospitals. Seventeen other states have similar scholarship tax credit programs, authorized between 1997 and 2017.

In response to the TCJA, New York, New Jersey, and other states passed laws to offer similar credits to taxpayers who made donations to state or local government-run funds, with the proceeds to be used to pay for government services that would otherwise be funded through taxes. Treasury didn't care much for states undermining a key provision of the new tax law, so in August 2018 it issued draft regulations to block them, but the proposed solution would also have applied to the existing, private-charitable tax credit programs like Georgia's. In June of this year, Treasury announced the final regulation, which included some important changes from the original.<sup>1</sup>

The August version of the regulation had two side effects on the existing state tax credit programs beyond blocking the SALT deduction cap workarounds — one that rightly closed loopholes, and another perhaps unintentional. The loopholes — one created by the TCJA and another pre-TCJA that applied to those subject to alternative minimum tax — would have allowed individual taxpayers to profit from their donations to charitable tax credit programs like

<sup>1</sup> Contributions in Exchange for State or Local Tax Credits, REG-112176-18, Docket ID: IRS-2018-0025; see also Robert D. Buschman, “Low-SALT Rules: Charitable Contributions for State Tax Credits,” *State Tax Notes*, Oct. 29, 2018, p. 443.

Georgia's scholarship and rural hospital credits, and similar programs in other states.

Before the TCJA, donor taxpayers were trading — dollar for dollar — charitable contributions for lower state income taxes. When they filed their federal taxes, they claimed higher itemized deductions for gifts to charity and offsetting lower deductions for SALT paid. It was generally a wash, unless they owed AMT.<sup>2</sup>

The TCJA changed that. For taxpayers with SALT over the \$10,000 limit, there would be no offsetting reduction in SALT deductions, but they could still claim the charitable gift deduction even though they received a 100 percent tax credit.<sup>3</sup> For a 35 percent bracket taxpayer, a \$1,000 donation would return a \$1,000 state tax credit and a \$1,000 federal charitable gift deduction, reducing their federal taxes by \$350. Their state tax liability would be reduced by the same \$1,000, but if that liability was still at least \$10,000, the amount they could deduct under the TCJA would remain the same. There would be no offset to the \$350 tax savings from the charitable deduction, leaving them with a 35 percent return on a short-term outlay of the funds donated to the charitable fund and returned in the form of a tax credit.

The August draft regulation to block the SALT deduction cap workarounds would have closed that loophole by denying the charitable gift deduction whenever the tax credit given exceeded 15 percent of the donation. However, the proposed rule may have hurt programs like Georgia's scholarship and rural hospital credits. For both business taxpayers, for whom there is no SALT deduction cap, and individuals whose itemized SALT deductions aren't over the cap, the rule would have created a tax cost for the donation that didn't exist pre-TCJA. The taxpayer would lose both the charitable gift deduction and the SALT deduction, so they would owe additional federal tax equal to the amount of the

donation times their federal tax rate. A corporate taxpayer making a \$10,000 donation to a rural hospital would still get a 100 percent credit on its state taxes, but its federal taxable income would be \$10,000 higher, costing it \$2,100 in added tax at the 21 percent federal corporate tax rate.

There is evidence that uncertainty about this regulation caused some Georgia taxpayers to hold back on their donations in 2019. Credits for donations to eligible student scholarship organizations must be preapproved by the state's Department of Revenue, which begins accepting applications for that year's donations at the start of each calendar year. In recent years, applications for the state's scholarship tax credit received by the first business day of the year far exceeded the annual maximum of available credits.<sup>4</sup> In 2018, about \$105 million of credit applications were received by the DOR on January 2, the first day they could be submitted. Credits were capped at \$58 million, so applicants were preapproved for a prorated amount — 55 percent of the amount requested. The year before, the cap was reached on January 3 with about \$116 million of credit applications, which were prorated by 50 percent to \$58 million.

For 2019, that changed. Though the cap was increased to \$100 million for 2019, as of May 22 (the last report before the IRS rule was finalized) only \$97.8 million of scholarship tax credit applications had been processed, and thus the new cap had not been reached nearly five months into the year. As of June 30, \$98.6 million of scholarship tax credits have been preapproved.

The state's rural hospital credit is newer, and only in 2018 was the credit rate increased to 100 percent, so there is no comparable history of reaching the cap quickly, but the preapproval cap of \$60 million for 2018 was reached by June 30, according to the DOR.<sup>5</sup>

For 2019, only \$24.5 million of credit applications had been processed as of May 31.<sup>6</sup> An

<sup>2</sup> Because AMT doesn't allow deductions for state taxes, but does for charitable contributions, AMT payers could reduce their federal tax liability by converting state tax liability to charitable gifts through state charitable contribution tax credits. The AMT savings could be 28 percent of the amount donated for high earners, or more for AMT payers with incomes in the exemption phaseout range.

<sup>3</sup> For a detailed legal analysis of the full deductibility of charitable gifts in the presence of state tax benefits, see Joseph Bankman et al., "State Responses to Federal Tax Reform: Charitable Tax Credits," *State Tax Notes*, Apr. 30, 2018, p. 433.

<sup>4</sup> See Georgia Department of Revenue, Qualified Education Expense Tax Credit, cap status reports for 2013-2019.

<sup>5</sup> The DOR reopened the rural hospital credit for new applications in November 2018 based on preapprovals for which the donor did not fund the full amount preapproved. The preapproval cap was reached again before year end.

<sup>6</sup> See Georgia Department of Revenue, "2019 Rural Hospital Organization Expense Credit," cap status report as of May 31, 2019.

additional \$1.7 million of rural hospital credit applications were approved in June, according to the department, bringing the total to about 44 percent of the \$60 million cap amount.

On June 11 Treasury announced the final regulation, which, along with a related notice issued January 22, resolved the issues with the August draft regulation while still blocking the SALT deduction limit workaround attempts and closing the loophole created by the TCJA that would have enabled some filers to profit from their donations. The rule is applicable to donations made beginning on August 27, 2018, the date of the proposed rule. The final rule still denies the charitable gift deduction to the extent of the credit whenever it exceeds 15 percent of the donation, but two safe harbors eliminate the federal tax cost of the original rule for business donors and for individuals who do not reach the cap on SALT deductions. The January notice created a safe harbor for businesses, allowing them to treat the charitable donation as a business expense, even though they would not ordinarily qualify under section 162.<sup>7</sup> For individual taxpayers, the final rule creates a safe harbor allowing them to treat their donation as a state or local tax payment, deductible as an itemized deduction if they are not already over the limit.

Thus, the pre-TCJA order for these private-charitable tax credits is restored. Donors neither profit nor lose by turning some of their state income tax liability into funding for scholarships or rural hospitals. Meanwhile, high-tax states are denied their TCJA workarounds, as the rule was intended. Taxpayers donating to these programs will be unable to reduce their federal tax liability by recharacterizing their limited SALT payments as charitable contributions. ■

<sup>7</sup> Rev. Proc. 2019-12, see IRB 2019-04 (Jan. 22, 2019).

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