Low-SALT Rules: Charitable Contributions for State Tax Credits

by Robert D. Buschman

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In this article, the author examines the charitable contribution deductions for donations to Georgia's scholarship and rural hospital tax credit programs before and after the enactment of the federal Tax Cuts and Jobs Act for both individual and corporate taxpayers.

News of proposed federal tax regulations that could end charitable contribution deductions for donations to Georgia's scholarship and rural hospital tax credit programs raises concerns about those programs' future.[1] To understand those concerns and to gauge what impact the regulation might have, it is important to understand the full tax story on those credits, how they were treated before the Tax Cuts and Jobs Act (P.L. 115-97), how they are treated after TCJA absent the proposed regulation, and what would change if the regulation is adopted.

Step back to spring of 2017, when a national School Superintendents Association report asserted that "rich donors could make money" by donating to student scholarship organizations in Georgia and double dipping on tax benefits, taking both a charitable deduction on their federal returns and a 100 percent credit on their state returns.[2] Someone in the 35 percent federal tax bracket, for example, could convert $1,000 of state tax liability to a charitable contribution and save $350 on her federal taxes by deducting it, even though the credit fully offsets the donation.[3] While there was a federal tax loophole that may have benefited some taxpayers, for most individual and all corporate taxpayers it really was not possible to turn a profit on those donations.

This is in the news again now because of the proposed IRS regulation, which is meant to prevent some high-tax states from circumventing the TCJA's $10,000 limit on the state and local tax deduction.[4] Several states have proposed copying state tax credit programs such as Georgia's, giving their taxpayers up to 100 percent tax credits for donating to a state-controlled fund, which would then be used to fund government services. Absent the regulation, taxpayers in those states could then deduct the full amount of their state and local taxes, despite the TCJA limit, by recharacterizing the portion over the TCJA's SALT limit as a charitable contribution.

Some are now concerned that the proposed regulation will hurt the scholarship and rural hospital programs if it takes away donors' ability to take a charitable contribution deduction on their federal returns. This interpretation is also incomplete — and the missing piece is the SALT deduction.

This article lays out the tax math for personal and corporate income tax payers under the old,

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[1] James Salzer and Ty Tagami, "IRS Proposal Could Hurt Georgia Rural Hospital, School Tax Credits," *The Atlanta Journal-Constitution*, Aug. 27, 2018.

[2] Tagami, "Superintendents Attack Scholarship Tax Credits as 'Profitable' for Rich," *The Atlanta Journal-Constitution*, May 18, 2017.

[3] Actually, as will be explained later, that's not really the full tax story.

[4] Contributions in Exchange for State or Local Tax Credits, 83 Reg. section 43563 (proposed Aug. 23, 2018).

pre-TCJA law as well as post-TCJA, both with and without the proposed IRS regulation. It explains what loophole existed before, how the TCJA made it bigger, how the proposed regulation would close it, and how it might also have unintended consequences. It also provides data on one of Georgia's programs, the scholarship tax credit, that may provide some clues about the degree to which donors might have benefited from the old-law treatment under the alternative minimum tax and the degree to which contributions might be affected in the future.

Pre-TCJA Tax Treatment

Under the old federal law, donors to Georgia's scholarship and rural hospital programs got a charitable contributions deduction on their federal return for the year of the donation, along with their unlimited SALT deduction, and then got a credit for 100 percent of the donation on their state return. But because of the credit, they would also see their SALT deduction reduced by the same amount as the charitable contributions deduction increase, resulting in no change in their overall itemized deductions. Thus, for most filers, any tax savings from the charitable deduction was offset by the tax cost of the reduced SALT deduction and there was no profit from double dipping.

Under the aforementioned example, the $350 federal tax saving from the $1,000 charitable deduction is offset by a $350 tax cost from the $1,000 smaller SALT deduction. The same is true for corporate filers pre-TCJA; higher charitable deductions are offset by an equal reduction in state tax deductions.

The only exception is personal income tax payers subject to the federal AMT. Under the AMT, no SALT deduction is allowed, but charitable contributions are fully deductible as under the regular tax rules. So filers who owe AMT get the benefit of the larger charitable deduction, but not the cost from losing part of their SALT deduction. The taxpayer from the example, one in the 35 percent tax bracket for the regular tax, would likely face a 28 percent marginal rate under the AMT, so the $1,000 donation would earn her a $1,000 credit on her Georgia taxes while saving her $280 in federal taxes, for a "profit" of $280 from the federal tax savings.

Corporate taxpayers, on the other hand, could not benefit in the way AMT payers could. State and local taxes were fully deductible for corporate taxpayers, even under the AMT, so the increased charitable contribution deduction would still be offset by a corresponding reduction in the deduction for state taxes paid for those taxpayers.

How Big Was the Personal AMT Loophole?

The existence of this quirk in the tax code for AMT payers raises the question of how widespread its use was relative to the total amounts donated to the scholarship and rural hospital programs. Unfortunately, the latter is too new for data to be available, but based on 2015 Georgia tax return data, about 16,300 personal income tax filers used scholarship tax credits that year, totaling almost $27 million in used credits. Note that total contributions by individual taxpayers in 2015 were higher, about $34.7 million, but because the credit is nonrefundable, many taxpayers were not able to fully use the credits earned on their 2015 tax returns and would have carried a portion forward.

Of those returns using the credit, just under 14,000 — representing about $23.3 million of credits — could be matched to available federal data to determine whether they paid AMT for the same year. Of those, about 4,400 paid AMT and used scholarship tax credits totaling $8.4 million (about 36 percent of credits from matched returns). Assuming a similar share of donor returns that could not be matched to federal data were also AMT payers, then we estimate that about 5,200 filers could have benefited from the loophole on about $9.7 million of used credits in 2015.

Given that AMT filers tend to be high-income taxpayers, we assume no need to carry unused credits forward, thus those returns would also represent about $9.7 million for contributions to scholarship organizations. Total scholarship tax credit donations in 2015, including those made by corporate filers, were $52.8 million, so we estimate the share of tax credits earned in 2015 by personal AMT payers at about 18 percent. Whether those contributions would have been made had the opportunity for AMT payers to benefit not existed is, of course, unknowable.

Post-TCJA, Closing a Bigger Loophole

In a post-TCJA world without the proposed IRS regulation, the federal tax treatment of contributions by AMT payers is extended to all personal income tax payers, though not corporate taxpayers. SALT deductions are capped under the TCJA, so if the donor's state and local taxes are going to exceed the SALT cap even after the effect of the credit, then the amount of their SALT deduction does not change; it is still $10,000. In this case, absent the proposed regulation, they get the full benefit in federal tax savings from taking the charitable deduction and never realize the federal tax hit from lower SALT deductions. Such a taxpayer stands to make a significant profit; for the taxpayer in the 35 percent regular tax bracket, the same $1,000 donation this year would return $1,350 by the time he files his taxes — the $1,000 state credit plus $350 of federal tax savings and no offsetting federal tax cost from a lower state tax deduction.

Thus, absent this regulation, the TCJA creates the opportunity for profit for regular taxpayers that was only possible for AMT payers before the TCJA. By denying the charitable contributions deduction with the new regulation, the IRS is closing both loopholes: the one created for all personal income tax payers by the TCJA and the one only available to AMT payers before.

Unintended Consequences

Given the complexities of federal income taxation, it is probably not surprising that the proposed regulation may have unintended consequences — apparently two in this case.

First, as noted, the TCJA created a loophole for non-AMT payers with larger SALT deductions, large enough to be over the TCJA cap even after the tax credit. For those with smaller SALT deductions, however, the proposed regulation creates a significant tax cost for making scholarship or rural hospital contributions and taking the credit. This happens because unlike the higher SALT deduction group, their SALT deduction would be reduced by the amount of the credit, but they would get no charitable contribution deduction to offset the reduced SALT deduction. The draft regulation acknowledges this federal tax cost in its illustrative scenarios for different types of taxpayers, but it's worth noting that under the TCJA, many of those taxpayers may no longer itemize deductions anyway. If they take the standard deduction instead, then there is no net tax cost or profit in making those contributions.

The story is different for corporate taxpayers. The same section of the tax code (section 170) that provides for the charitable contributions deduction for individuals also provides it to corporate taxpayers, and it is this section to which the proposed regulation applies. Again, the TCJA does not cap SALT deductions for corporations. Thus, if corporations also lose the ability to deduct the charitable contribution when they receive the credit, they will pay more in federal taxes because their deduction for state income taxes will be reduced by the amount of the credit. A corporation making a $10,000 contribution for scholarships or rural hospitals would find its federal taxable income increased by that amount, resulting in it owing $2,100 more in federal taxes at the TCJA corporate tax rate of 21 percent. Considering that corporate donors accounted for about 34 percent of scholarship tax credits in Georgia in 2015, this seems a greater reason for concern than the effects of the regulation on individual taxpayers.

The IRS has attempted to clarify how the regulation would affect corporate donors by issuing a statement reminding us that payments by businesses to charitable organizations can be deductible business expenses under IRC section 162.[5] However, this section is clear that to be deductible as a business expense, the payment must be for an ordinary and necessary business expense. IRS Publication 535, "Business Expenses," further instructs taxpayers that:

> Cash payments to an organization, charitable or otherwise, may be deductible as business expenses if the payments aren't charitable contributions or gifts and are directly related to your business. If the payments are charitable contributions or gifts, you can't deduct them as business expenses.[6]

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[5] Clarification for business taxpayers: Payments under state or local tax credit programs may be deductible as business expenses. IR-2018-178 (Sept. 5, 2018).

[6] "Business Expenses," IRS Pub. 535 (2017), at 45.

So, for example, payments to a local nonprofit youth sports organization to pay for uniforms or a scoreboard that would also advertise the business can be a deductible business expense under section 162, but simply donating to a charity would not, though ordinarily it could still be deducted as a charitable contribution under section 170. However, if the charitable contribution were disallowed under the proposed regulation because of an offsetting tax credit, absent further clarification there would be no clear avenue for deducting the gift.

There may be workarounds, of course. The charitable organizations could, for example, raise money through sponsorships instead of donations, with the advertising or other consideration given perhaps qualifying the payment as a business expense. But valuing the consideration given by a scholarship or rural hospital organization in exchange for the payment — that is, justifying a valuation that always equals the payment — could introduce unnecessary complexity and risks for the organizations and for taxpayers.

A better solution may be a rule in which the IRS would deem a payment made to a charity that is offset by a state tax credit to be functionally the same as a tax payment and thus a deductible expense of the business. This could solve the problem of the proposed regulation for corporate donors because their deduction for state taxes would not be reduced and their federal tax liability would not rise as a result of their contribution. It would also address the issue for individuals with SALT deductions below the limit in the same way. Finally, that kind of rule would not reopen the loopholes before or after the TCJA for individual taxpayers and would not reopen the door to the high-tax state workarounds for the TCJA SALT limitation that apparently prompted the proposed regulation.

Conclusions

Based on the analysis of the changing tax law under the TCJA and the proposed IRS regulation, and on what's known about contributors to the Georgia scholarship tax credit program, it seems fair to draw two conclusions. First, in the post-TCJA tax world, a regulation denying the charitable deduction when contributions earn a tax credit would really do nothing more for most personal income tax payers (those with SALT deductions at the cap even after the state credit) than to restore the pre-TCJA status quo, and would for personal AMT payers close a loophole that existed before the TCJA. At the same time, however, denying the charitable contributions deduction for corporate contributions to those tax credit programs introduces a significant cost that was not there before the TCJA, or even after the TCJA absent this regulation. This second point appears to justify the concern that contributions to the scholarship and rural hospital programs could fall significantly if this regulation is adopted as drafted, but that concern could be alleviated with further modification of the proposed regulation. ■