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TO: Our Clients and Friends

FROM: Grossman Yanak & Ford LLP

REGARDING: IRS Aims to Limit Charitable Contributions Made to Avoid SALT Deduction Limit

LEVEL OF IMPORTANCE: High

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IRS Aims to Limit Charitable Contributions Made to Avoid SALT Deduction Limit

As has been discussed frequently in our posts, the Tax Cuts and Jobs Act of 2017 limited the amount of state and local taxes (SALT) deductible as an itemized deduction starting in 2018 through 2025 to \$10,000. This limitation applies to the total of real property taxes, state income taxes and local income taxes. The deduction was replaced somewhat by an expansion of the standard deduction.

The new rules and limitation have not been well received by those living in higher tax rate states where SALT can often be a material item. To attempt an end-around to the new limitations, certain states have created various schemes that work to re-characterize these expenses as charitable contributions.

Note that these new schemes differ from programs such as the Pennsylvania Education Improvement Tax Credit (EITC) program. The Commonwealth's program has been a long-standing and successful means of improving qualifying Pennsylvania schools and was not designed to avert the new tax deduction limitation. The program was adopted to allow taxpayers to send monies otherwise due to the state directly to the qualifying educational institutions that they chose to support by giving to those charitable institutions. Even though the Pennsylvania program was not designed as an end-around to the new federal law, the question of whether the new provision would limit the federal deduction of these payments for such historical programs remained unanswered...until now.

In [Internal Revenue Service Notice IR-2018-172](#), the Service announced the issuance of newly-proposed Treasury regulations addressing this matter. Under the proposed rules, an individual, estate, and trust generally must reduce the amount of any charitable contribution deduction by the amount of any state and local tax (SALT) credit he or she receives or expects to receive for the transfer.

The rules will serve to block attempts by state and local governments to get around the new SALT deduction dollar limits by adopting such devices.

A Primer on the SALT Limit

Beginning in 2018, an individual's itemized deduction of SALT is limited to \$10,000 (\$5,000 if married filing separately). Several states and local governments have adopted or are considering adopting laws that allow individuals to receive a tax credit for contributions to funds "controlled" by the state and local government. Their aim is to get around the SALT deduction limit by creating a charitable deduction, which is not limited, for federal income tax purposes.

Regardless of state and local law, the Internal Revenue Service makes clear in the preamble to the proposed regulations (and previously in Notice 2018-54), that federal law controls when determining charitable contribution deductions for federal income tax purposes. This finding by the Internal Revenue Service is clear and unequivocal.

State Income Tax "Return Benefit"

In light of existing case law, regulations and tax principles, the proposed regulations provide that the receipt of a SALT credit for a charitable contribution is the receipt of a "return benefit" (quid pro quo benefit). As a result, if a taxpayer makes a payment or transfers property to an Internal Revenue Code Section 170(c) entity (or some intermediary entity), he or she must reduce any charitable contribution deduction for federal income tax purposes if he or she receives (or expects to receive) a SALT credit in return.

Mechanics of the Calculation

Under the proposed regulations, a taxpayer who makes payments or transfers property to an entity eligible to receive tax deductible contributions must reduce their charitable deduction by the amount of any state or local tax credit the taxpayer receives or expects to receive.

For example, if a state grants a 70 percent state tax credit and the taxpayer pays \$1,000 to an eligible entity, the taxpayer receives a \$700 state tax credit. The taxpayer must reduce the \$1,000 contribution by the \$700 state tax credit, leaving an allowable contribution deduction of \$300 on the taxpayer's federal income tax return. The proposed regulations also apply to payments made by trusts, descendants' estates, or other intermediary entities in determining the amount of their contribution deduction.

De Minimis Exception

The taxpayer's charitable contribution is not reduced dollar-for-dollar for any SALT credit benefit under the proposed regulations if the contribution amount is de minimis. The de minimis exception provides that the taxpayer may disregard up to 15 percent of the payment or transfer to the charitable organization. For example, if a taxpayer makes a charitable contribution of \$1,000, he or she is not required to reduce the charitable deduction by \$1,000 if the SALT credit is no more than \$150. If the credit however is in excess of 15% of the contribution, the entire contribution amount is disallowed.

Pennsylvania's Educational Improvement Tax Credit ("EITC")

Generally, Pennsylvania's EITC program allowed either a 90 percent credit for a two year charitable commitment or 75 percent for a single year commitment. Under the proposed regulations, participating taxpayers would only be entitled to a federal income tax deduction for either 10 percent or 25 percent of their contribu-

tion. Note that the proposed federal regulations will not limit the ability to utilize the Pennsylvania tax credit which provides the majority of the tax savings for using the program.

The question arises as to whether the Pennsylvania program is sufficiently beneficial to merit continued participation by taxpayers.

If one were going to give \$10,000 to a qualifying school under the EITC program in the past, he or she would be granted a 90 percent credit against their Pennsylvania income tax liability (assuming a two year commitment).

In addition, the taxpayer would be entitled to an itemized deduction for the entire \$10,000 contribution. If he or she is assumed to be in the 35 tax bracket, the federal taxes saved would be \$3,500. Thus, the taxpayer received a \$9,000 state credit (reducing their tax liability dollar for dollar plus a \$3,500 federal income tax savings). As such, taxpayers found themselves “in the money” as they essentially received a \$12,500 economic benefit for a \$10,000 expenditure.

After the passage of the new tax law, the state element of the deduction is the same. In the above example, the taxpayer receives a \$9,000 credit, reducing their state income tax liability, again, dollar for dollar.

However, under the newly-released proposed regulations, the amount of the federal income tax deduction is reduced to \$1,000 (\$10,000 charitable contribution less \$9,000 state tax credit or return benefit). Assuming the same tax rate, the federal tax savings is \$350. As such, the economic benefit after the change in the law is \$9,350, or 93.5% of the amount contributed.

The question as to the continued benefit of the Pennsylvania EITC program depends on the intent of the donor/taxpayer. If they plan, in any case, to contribute funds to a qualifying educational institution, the EITC program may still be beneficial.

Using the same example, if the EITC program is not utilized and the contribution is made directly to qualifying educational organization, the federal tax savings would be 35 percent or \$3,500. If, however, the taxpayer elects to continue the EITC program, their economic benefit for the same \$10,000 expenditure would be \$9,350, as explained above.

Effective Date

These rules are proposed to apply to contributions after August 27, 2018 when they will be published in the Federal Register. Please feel free to contact Bob Grossman or Don Johnston with questions or comments.

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