

# Charity Groups Fret Over Upcoming SALT-Deduction Rules

Some worry that an IRS effort to disallow a workaround to a new cap on state and local tax deductions will ensnare existing tax breaks for donations to schools, hospitals, and other organizations.



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**T**he Internal Revenue Service and high-tax states like California, New Jersey, and Connecticut are headed for a confrontation over the new cap on the state and local tax deduction—and smaller charities may become collateral damage.

December's tax-code overhaul included a number of revenue raisers to help pay for the steep cuts to individual and corporate tax rates. One of the more controversial was a new \$10,000 cap on the federal deduction for state and local taxes, or SALT.

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Several high-tax, largely Democratic-controlled states have crafted bills aimed at allowing their taxpayers to circumvent the new deduction cap. Many involve taxpayers donating to a state-run charity that funds governmental functions like public-school systems. The contribution counts toward an individual's state and local tax liability via a credit, while allowing them to use the charitable deduction—which doesn't have the \$10,000 cap—on their federal tax bill as well.

In late May, the IRS issued its response to the state proposals, announcing plans for rules “addressing the deductibility of state and local tax payments for federal income tax purposes.” It's likely the new rules will be an attempt to disallow the state charity workarounds, but depending on the language, their scope could extend well beyond the intended targets.

“Our concern is that the IRS, in the process of writing rules and regulations that will prevent these sort of workarounds, will unwittingly or unnecessarily clamp down on legitimate areas where there are some intersections between the charitable world and government,” said Sean Parnell, vice president for public policy at the Philanthropy Roundtable.

Charity groups fear that the upcoming rules could prevent taxpayers from donating to state-sponsored charities, or at least prevent them from deducting the contribution from their federal taxes, sending donors in search of more tax-advantaged philanthropic pursuits. The issue is that state-sponsored charities have existed long before the proposed SALT-cap workarounds. There are more than 100 programs in some 33 states in which taxpayers can donate to a state-affiliated charity and receive a tax credit, all while retaining the federal charitable deduction.

“The IRS, I presume, understands it's under some pressure to do something about these programs but at the same time understands that there's no simple solution, and it's struggling to come up with a way of somehow distinguishing these newer programs from older programs,” said Darien Shanske, a professor at the University of California, Davis School of Law.

Those older programs run the gamut from an Alabama organization that provides private-school scholarships to students from low-income families, to a Louisiana tax credit for donations to public playgrounds, to a program in Georgia helping fund rural hospitals. The Georgia program, called Helping Enhance Access to Rural Treatment, is the product of state legislation and offers a state income-tax credit on 100 percent of contributions.

Kirk Stark, a UCLA tax law professor, said that because the Georgia hospital program involves donations to government-run entities, it highlights the challenge the IRS may have in crafting rules that only go after the charity workarounds proposed by California and New Jersey and others, while keeping clear of smaller-scale programs.

“Some of those hospitals are nonprofits, and a lot of those hospitals are hospital authorities; they’re public entities under Georgia law,” Stark said.

John Schilling, president of the American Federation for Children, said he and others are concerned that the new rules could affect scholarship-granting organizations that offer similar state tax credits.

“We know that our allies in the states are having a lot of conversations with their delegations about this issue just to make sure they do in fact promulgate narrow rules,” said Schilling, whose group advocates school choice.

The American Federation for Children and other education-advocacy groups have sent a letter to Treasury Secretary Steven Mnuchin and Education Secretary Betsy DeVos pressing for narrowly written regulations.

Stark, Shanske, and other law professors published a paper in January defending taxpayers’ ability to receive both the state tax credits and the federal charitable deduction, known as the Full Deduction Rule, for donations to such programs.

The IRS could move to eliminate the rule, limiting the federal charitable deduction to the portion not offset by the state tax credit. But the authors of the paper argue that the rule is long-established and has legal precedent. Whether the IRS can eliminate the rule without legislation is unclear as well, they say.

Moreover, Section 170, the part of the tax code governing charitable deductions, specifically includes states as a qualified recipient of charitable donations. So disallowing the federal charitable deduction for donations to state-sponsored groups would be a “repudiation of the statute as enacted by Congress,” Stark said.

In its notice, the IRS said it planned to follow a “substance-over-form” principle, which could mean that the agency will mandate that state charities must reflect the spirit of the regulation in addition to the strict legal language.

“That signals that there’s no broader principle of tax law, any statute or ruling, or any particular reason why the proposed SALT workarounds shouldn’t work, hence they’re going to issue a new regulation relying on this backup doctrine,” Shanske said.

Not all analysts agree. Jared Walczak, a policy analyst at the Tax Foundation, has called the charity SALT workarounds “legally dubious,” and “aggressive tax avoidance tactics using contributions which lack donative intent.”

Congress could pass legislation changing Section 170 or eliminating the Full Deduction Rule, but lawmakers still in the same box as IRS rule-makers: it’s unclear how they will write language exempting the preexisting charities.

Programs offering state tax credits for certain donations isn’t a new concept, and neither is the idea that they can be used as a workaround to deduct state and local tax payments at the federal level. Tax professionals have advised individuals caught by the Alternative Minimum Tax go after the state tax credits for years.

“Millions of people who were subject to the AMT could already take no SALT deduction and were already using these programs from the beginning, and that didn’t seem to alarm anyone,” Shanske said.



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