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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9864]

RIN 1545-BO89

Contributions in Exchange for State or Local Tax Credits

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains a final regulation under section 170 of the Internal Revenue Code (Code). The final regulation provides rules governing the availability of charitable contribution deductions under section 170 when a taxpayer receives or expects to receive a corresponding state or local tax credit. This document also provides a final regulation under section 642(c) to apply similar rules to payments made by a trust or decedent's estate.

DATES: Effective date: These regulations are effective **[INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability dates: For dates of applicability, see §1.170A-1(h)(3)(viii) and §1.642(c)-3(g)(2).

FOR FURTHER INFORMATION CONTACT: Mon L. Lam or Richard C. Gano IV at (202) 317-4059 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

## **Background**

Section 170(a)(1) generally allows an itemized deduction for any “charitable contribution” paid within the taxable year. Section 170(c) defines “charitable contribution” as a “contribution or gift to or for the use of” any entity described in that section. Under section 170(c)(1), such an entity includes a State, a possession of the United States, or any political subdivision of the foregoing, or the District of Columbia. Entities described in section 170(c)(2) include certain corporations, trusts, or community chests, funds, or foundations, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals.

To be deductible as a charitable contribution under section 170, a transfer to an entity described in section 170(c) must be a contribution or gift. A contribution or gift for this purpose is a voluntary transfer of money or property without the receipt of adequate consideration, made with charitable intent. In Rev. Rul. 67-246, 1967-2 C.B. 104, the Internal Revenue Service (IRS) addressed the taxpayer’s burden of proof for establishing charitable intent when the taxpayer receives a privilege or benefit in conjunction with its contribution. In this revenue ruling, the IRS set out a two-part test for determining whether the taxpayer is entitled to a charitable contribution deduction under these circumstances. First, the taxpayer has the burden of proving that its payment to the charity exceeds the market value of the privileges or other benefits received. Second, the taxpayer must show that it paid the excess with the intention of making a gift.

In United States v. American Bar Endowment, 477 U.S. 105, 116-18 (1986), the Supreme Court elaborated on the test set out in Rev. Rul. 67-246. The Court interpreted the phrase “charitable contribution” in section 170 as it relates to the donor’s receipt of consideration, and stated that the “*sine qua non* of a charitable contribution is a transfer of money or property without adequate consideration.” Id. at 118. The Court concluded that “[a] payment of money generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return,” (id. at 116), (hereinafter referred to as the “quid pro quo principle”). The Court recognized that some payments may have a “dual character” — part charitable contribution and part return benefit. Id. at 117. The Court reasoned that in dual character cases “it would not serve the purposes of section 170 to deny a deduction altogether”; therefore, a charitable deduction is allowed, but only to the extent the amount donated or the fair market value of the property transferred by the taxpayer exceeds the fair market value of the benefit received in return, and only if the excess amount was transferred with the intent of making a gift. Id. See also Hernandez v. Commissioner, 490 U.S. 680, 690 (1989) (stating that Congress intended to differentiate between unrequited payments and payments made in return for goods or services). Because this inquiry focuses on the donor’s expectation of a benefit, it does not matter whether the donor expects the benefit from the recipient of the payment or transfer, or from a third party. See, for example, Singer Co. v. United States, 449 F.2d 413, 422-23 (Ct. Cl. 1971); cited with approval in American Bar Endowment, 477 U.S. at 116-17.

In Hernandez, 490 U.S. at 690-91, the Supreme Court reaffirmed the quid pro quo standard articulated in American Bar Endowment. Specifically, the Court held that

payments to a charity that entitled the taxpayers to receive an identifiable benefit in return for their money were part of a “quintessential *quid pro quo* exchange,” and thus, were not contributions or gifts within the meaning of section 170. *Id.* at 691. In making this determination, the Court noted the importance of examining the “external features of a transaction,” thereby “obviating the need for the IRS to conduct imprecise inquiries into the motivations of individual taxpayers.” *Id.* at 690-91. Thus, both American Bar Endowment and Hernandez indicate that objective considerations guide the determination of whether the taxpayer purposely contributed money or property in excess of the value of any benefit received in return. In addition, these cases continue to recognize the requirement that the taxpayer have charitable intent. See American Bar Endowment, 477 U.S. at 118; Hernandez, 490 U.S. at 691.

Section 164 generally allows an itemized deduction for the payment of certain taxes, including state and local, and foreign, real property taxes; state and local personal property taxes; and state and local, and foreign, income, war profits, and excess profits taxes. Section 164(b)(6), as added by section 11042 of “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018” (“the Act”), Pub. L. 115-97, limits an individual’s deduction for the aggregate amount of state and local taxes paid during the calendar year to \$10,000 (\$5,000 in the case of a married individual filing a separate return). This limitation applies to taxable years beginning after December 31, 2017, and before January 1, 2026. This limitation does not apply to foreign taxes described in section 164(a)(3) or to any taxes described in section 164(a)(1) and (2) that are paid and incurred in carrying on a trade or business or an activity described in section 212.

In response to the new limitation under section 164(b)(6), some taxpayers are seeking to pursue tax planning strategies with the goal of avoiding or mitigating the limitation. These strategies rely on state and local tax credit programs under which states provide tax credits in return for contributions by taxpayers to or for the use of certain entities described in section 170(c). The use of state or local tax credits to incentivize charitable giving has become increasingly common over the past 20 years. Moreover, since the enactment of the limitation under section 164(b)(6), states and local governments have created additional programs intended to work around the new limitation on the deduction of state and local taxes.

The new limitation, and the resulting efforts by states and taxpayers to devise alternate means for deducting the disallowed portion of their state and local taxes, has generated increased interest in the question of whether a state or local tax credit should be treated as a return benefit – a quid pro quo – when received in return for making a payment or transfer to an entity described in section 170(c). The Treasury Department and the IRS did not publish formal guidance on this question before the enactment of the limitation under section 164(b)(6). In 2010, however, the IRS Chief Counsel advised that, under certain circumstances, a taxpayer may take a deduction under section 170 for the full amount of a contribution made in exchange for a state tax credit, without subtracting the value of the credit received in return. See CCA 201105010 (Oct. 27, 2010) (“the 2010 CCA”). IRS Chief Counsel has also taken the position in Tax Court litigation that the amount of a state or local tax credit that reduces a tax liability is not an accession to wealth includible in income under section 61 or an amount realized for purposes of section 1001. In these cases, the Tax Court agreed with the Chief

Counsel's position. See, for example, Maines v. Commissioner, 144 T.C. 123, 134 (2015); Tempel v. Commissioner, 136 T.C. 341, 351-54 (2011); aff'd sub nom. Esgar Corp. v. Commissioner, 744 F.3d 648 (10th Cir. 2014).

Upon reviewing the authorities under section 170, the Treasury Department and the IRS questioned the reasoning of the 2010 CCA. On June 11, 2018, the Treasury Department and the IRS issued Notice 2018-54, 2018-24 I.R.B. 750, announcing the intention to propose regulations addressing the federal income tax treatment of contributions pursuant to state and local tax credit programs. On August 27, 2018, the proposed regulations (REG-112176-18) were published in the **Federal Register** (83 FR 43563).

The proposed regulations generally stated that if a taxpayer makes a payment or transfers property to or for the use of an entity listed in section 170(c), and the taxpayer receives or expects to receive a state or local tax credit in return for such payment, the tax credit constitutes a return benefit, or quid pro quo, to the taxpayer and reduces the taxpayer's charitable contribution deduction. The proposed regulations included a separate rule for state and local tax deductions, providing that they do not constitute a quid pro quo unless they exceed the amount of the donor's payment or transfer. The proposed regulations also included an exception under which a state or local tax credit is not treated as a quid pro quo if the credit does not exceed 15 percent of the taxpayer's payment or 15 percent of the fair market value of the property transferred by the taxpayer. Finally, the proposed regulations would amend §1.642(c)-3 to provide similar rules for payments made for a purpose specified in section 170(c) by a trust or decedent's estate.

The Treasury Department and the IRS received over 7,700 comments responding to the proposed regulations and 25 requests to speak at the public hearing, which was held on November 5, 2018. Copies of written comments received and the list of speakers at the public hearing are available for public inspection at [www.regulations.gov](http://www.regulations.gov) or upon request. The comments and revisions are discussed generally in this preamble. After considering the comments received and the concerns expressed at the public hearing, the Treasury Department and the IRS adopt the proposed regulations with certain revisions explained subsequently.

Additionally, in response to concerns raised in comments, the Treasury Department and the IRS have issued other guidance providing safe harbors on certain issues. On December 28, 2018, the Treasury Department and the IRS issued Rev. Proc. 2019-12, 2019-04 I.R.B. 401, providing a safe harbor under section 162 for certain payments made by a C corporation or specified passthrough entity to or for the use of an organization described in section 170(c) if the C corporation or specified passthrough entity receives or expects to receive a state or local tax credit in return for such payment. On June 11, 2019, the Treasury Department and the IRS will have issued Notice 2019-12, 2019-27 I.R.B., providing a safe harbor for payments made by certain individuals. Under the safe harbor, an individual who itemizes deductions and makes a payment to a section 170(c) entity in return for a state or local tax credit may treat the portion of such payment that is or will be disallowed as a charitable contribution deduction under section 170 as a payment of state or local tax for purposes of section 164. This disallowed portion of the payment may be treated as a payment of state or local tax under section 164 when and to the extent an individual applies the state or

local tax credit to offset the individual's state or local tax liability. Notice 2019-12 requests comments for purposes of incorporating the safe harbor into anticipated proposed regulations under section 164. In general, the Treasury Department and the IRS will continue to consider comments and provide additional guidance in this area as needed.

## **Explanation of Provisions and Summary of Comments**

### Explanation of Provisions

The final regulations generally retain the proposed amendments set forth in the proposed regulations, with certain clarifying and technical changes. First, the final regulations retain the general rule that if a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c), and the taxpayer receives or expects to receive a state or local tax credit in return for such payment, the tax credit constitutes a return benefit to the taxpayer, or quid pro quo, reducing the taxpayer's charitable contribution deduction.

Second, the Treasury Department and the IRS have concluded that state tax credits and state tax deductions should be treated differently in light of policy and tax administration considerations identified in the preamble of the proposed regulations. Accordingly, the final regulations retain the rule that a taxpayer generally is not required to reduce its charitable contribution deduction on account of its receipt of state or local tax deductions. However, the final regulations also retain the exception to this rule for excess state or local tax deductions. Specifically, the taxpayer must reduce its charitable contribution deduction if it receives or expects to receive state or local tax

deductions in excess of the taxpayer's payment or the fair market value of property transferred by the taxpayer.

Third, the final regulations retain the 15-percent exception, under which a taxpayer may disregard state and local tax credits as a return benefit where such credits do not exceed 15 percent of the taxpayer's payment. However, the final regulations clarify that this 15-percent exception applies only if the sum of the taxpayer's state and local tax credits received, or expected to be received, does not exceed 15 percent of the taxpayer's payment or 15 percent of the fair market value of the property transferred by the taxpayer.

Fourth, the final regulations reflect the correction of a typographical error in §1.170A-1(h)(3)(i) of the proposed regulations. The introductory clause should refer to the 15-percent exception set forth in paragraph (h)(3)(vi), not paragraph (h)(3)(v). In addition, the final regulations clarify the terms used to describe entities that may receive charitable contributions under section 170(c). Specifically, the final regulations refer to entities "described" in section 170(c), rather than entities "listed" under section 170(c).

Finally, the final regulations include the proposed amendments to §1.642(c)-3 providing that the final rules under §1.170A-1(h)(3) apply to payments made by a trust or decedent's estate in determining its charitable contribution deduction under section 642(c).

## Summary of Comments

### 1. Comments in Support of the Proposed Regulations

Approximately 70 percent of commenters recommended that the Treasury Department and the IRS finalize the proposed regulations without change. Some

commenters characterized state and local tax credit programs as tax shelters and explained how taxpayers could use the programs to generate profits. A substantial number of commenters expressed concerns regarding the effect of these programs on public functions, including public education. Many commenters stated that the proposed regulations apply section 170 fairly. Many commenters noted that the proposed regulations applied to donations to organizations fulfilling both private and public purposes and applied to tax credit programs created both before and after the enactment of the Act. Some commenters stated that state tax credit programs are unfair to individuals who cannot afford to make the contributions and receive the benefit of the credits. Some commenters generally supported the proposed regulations, but provided more substantive comments regarding additional issues posed by the proposed regulations and requested additional guidance on those issues, either when finalizing the proposed regulations or in other guidance.

## 2. Section 170 Regulations in Response to a Section 164 Amendment

Many commenters wrote that it was improper for the Treasury Department and the IRS to issue regulations under section 170 in response to the enactment of section 164(b)(6). Commenters stated that any regulations must be issued under section 164 because an amendment to section 164 is driving the regulatory change.

The limitation under section 164(b)(6) is the impetus for the Treasury Department's and the IRS's consideration of the tax treatment of contributions made in exchange for state and local tax credits. Prior to the enactment of that limitation, the proper treatment of such contributions was of limited significance from a federal revenue perspective and tax administration perspective and was therefore never

addressed in formal guidance. Upon careful review of the issue, the Treasury Department and the IRS have determined that longstanding principles under section 170 should guide the tax treatment of these contributions. Section 170 provides a deduction for taxpayers' gratuitous payments to qualifying entities, not for transfers that result in receipt of valuable economic benefits. In applying section 170 and the quid pro quo principle, the Treasury Department and the IRS do not believe it is appropriate to categorically exempt state or local tax benefits from the normal rules that apply to other benefits received or expected to be received by a taxpayer in exchange for a contribution. The final regulations are consistent with longstanding principles under section 170 and sound tax policy. Therefore, the regulations are issued under section 170, and not section 164.

### 3. Treatment of State and Local Tax Credits as Return Benefits

Commenters expressed differing views of the proposed regulation's requirement that a taxpayer reduce the taxpayer's charitable contribution deduction under section 170 by the total amount of state and local tax credits received or expected to be received. Many commenters agreed with the Treasury Department and the IRS that the quid pro quo principle should be applied to the receipt or expectation of receipt of state and local tax credits. However, some commenters questioned the application and effect of the quid pro quo principle under section 170 and the tax consequences of such application.

The Treasury Department and the IRS have determined that it is appropriate to apply longstanding principles under section 170 that require a taxpayer to reduce the amount treated as a charitable contribution by the value of the return benefit received.

As discussed earlier in this preamble and in the preamble of the proposed regulations, the final regulations are consistent with the principle that a “payment of money generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return.” American Bar Endowment, 477 U.S. at 116. While the Supreme Court has not addressed the specific issue of contributions in exchange for state or local tax credits, the final regulations are a reasonable interpretation of section 170 that accords with the logic of American Bar Endowment and Hernandez. The final regulations are also supported by important tax policy considerations, including the need to prevent revenue loss from the erosion of the limitation under section 164(b)(6). Thus, the final regulations adopt the rule that the amount otherwise deductible as a charitable contribution under section 170 must generally be reduced by the total amount of state and local tax credits received or expected to be received.

a. Prior Chief Counsel Advice Memoranda and case law

Many commenters noted that the proposed regulations reflect a change in the IRS’s treatment of charitable contributions that result in state or local tax credits. The commenters pointed to several CCAs issued by IRS Chief Counsel from 2002 to 2010. See, for example, the 2010 CCA (addressing contributions of money or property to governments or charitable entities under several state tax credit programs); CCA 200435001 (July 28, 2004) (reviewing a program issuing state tax credits in return for contributions to certain child care organizations); CCA 200238041 (July 24, 2002) (considering a program issuing tax credits in return for the transfer of conservation easements). The preamble to the proposed regulations noted that, in each of these CCAs, IRS Chief Counsel recognized the complexity of the federal tax law issues

involving the tax treatment of the receipt or expectation of receipt of state tax credits, particularly where the tax credits are granted for transfers to section 170(c) entities.

The preamble also noted that two of the CCAs declined to provide specific guidance on the availability of the charitable contribution deduction, and suggested the issuance of formal guidance to address this question. Although CCAs are released to the public under section 6110, they are not official rulings or positions of the IRS, and cannot be cited as precedent. See sections 6110(b)(1)(A) and 6110(k)(3).

The Treasury Department and the IRS acknowledge that the proposed and final regulations depart from the conclusion of the 2010 CCA in important respects. As noted in the Background section of this preamble, the 2010 CCA concluded that a taxpayer may take a deduction under section 170 for the full amount of a contribution made in exchange for a state tax credit, without subtracting the value of the credit received in return. The 2010 CCA, however, failed to persuasively explain why state and local tax credits should not count as return benefits for purposes of applying the quid pro quo principle. The 2010 CCA cited cases in which courts had found that a donor's subjective motivation to minimize taxes is not a basis for disallowing a charitable deduction, but these cases did not specifically address whether the value of state or local tax credits should be treated as a quid pro quo that reduces the amount of the deduction. See McLennan v. United States, 24 Cl. Ct. 102,106 n.8 (1991); Skripak v. Commissioner, 84 T.C. 285, 319; Allen v. Commissioner, 92 T.C. 1, 7 (1989). The 2010 CCA also cited a case in which the value of a tax deduction was not treated as income under section 61, but that case did not address the application of the quid pro quo principle under section 170. See Browning v. Commissioner, 109 T.C. 303 (1997).

Furthermore, the analysis in the 2010 CCA assumed that after the taxpayer applied the state or local tax credit to reduce the taxpayer's state or local tax liability, the taxpayer would receive a smaller deduction for state and local taxes under section 164. With the enactment of section 164(b)(6), that assumption no longer holds true for the vast majority of taxpayers. The changes in the tax laws reduce the number of taxpayers who will itemize deductions, and for taxpayers who itemize and have state and local tax liabilities above the new limitation, the use of the tax credit would not reduce the deduction for state and local taxes.

In light of the section 164(b)(6) limitation, the Treasury Department and the IRS have specifically considered the application of the quid pro quo principle to state and local tax credit programs. After careful consideration of comments submitted in response to the proposed regulations, the Treasury Department and the IRS have determined that it is appropriate to treat the receipt or the expectation of receipt of state and local tax credits as return benefits. As discussed previously in this preamble, the final regulations are supported by the Supreme Court's interpretation of the term "charitable contribution" under section 170. In American Bar Endowment, 477 U.S. at 118, the Court stated that the "*sine qua non* of a charitable contribution is a transfer of money or property without adequate consideration"—that is, without the expectation of a quid pro quo. Thus, the Court held that a "payment of money generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return." Id. at 116. The Supreme Court reaffirmed this principle in Hernandez, 490 U.S. at 690-91, and this principle has been consistently applied by the courts in subsequent decisions. See, for example, Rolfs v. Commissioner, 135 T.C. 471 (2010), aff'd, 668

F.3d 888 (7th Cir. 2012) (holding that taxpayers were not entitled to a charitable contribution deduction for the donation of their lake house because they did not show that the market value of the property they donated exceeded the market value of the benefit (demolition services) they received in return); Triumph Mixed Use Investments III, LLC v. Commissioner, T.C. Memo. 2018-65 (holding that value of real property and development credits transferred by taxpayer to city in return for development plan approvals was not deductible under section 170 because taxpayer expected a return benefit); Pollard v. Commissioner, T.C. Memo. 2013-38 (holding that petitioner's granting of conservation easements to the county was part of a quid pro quo exchange for the county's approval of the taxpayer's subdivision exemption request, a substantial benefit to the taxpayer).

This treatment is consistent not only with the purpose of section 170, but also with the section 164(b)(6) limitation. If the Treasury Department and the IRS were to allow taxpayers to claim a full charitable contribution deduction for contributions made in exchange for state tax credits, this treatment would result in significant federal tax revenue losses that would undermine the limitation on the deduction for state and local taxes in section 164(b)(6). Such an approach would enable taxpayers to characterize payments as fully deductible charitable contributions for federal income tax purposes, while using the same payments to satisfy their state tax liabilities. As a result, the final regulations reject the 2010 CCA's conclusion that the contribution deduction does not need to be reduced by the value of the state and local tax credit received or expected to be received.

Commenters also cited recent cases, such as Maines v. Commissioner and Tempel v. Commissioner, to conclude that the receipt of a state or local tax credit is, for federal tax purposes, a reduction or potential reduction in the taxpayer's state or local tax liability and not a payment includible in the taxpayer's gross income. Maines, 144 T.C. at 134 (citing Randall v. Loftsgaarden, 478 U.S. 647, 657 (1986)); Tempel, 136 T.C. at 350; see also Rev. Rul. 79-315, 1979-2 C.B. 27 (Holding (3) (amounts credited against unpaid tax is neither includible in taxpayer's income nor deductible as a state income tax paid)). The analysis for determining whether an item is included in gross income is separate and distinct from the analysis for determining whether a payment or transfer is a deductible contribution under section 170. Section 61(a) provides that gross income "means all income from whatever source derived" unless otherwise provided in Subtitle A, Income Taxes. In contrast, to be deductible as a charitable contribution under section 170, a transfer to an entity described in section 170(c) must be a contribution or gift, without the expectation or receipt of a return benefit. Neither Maines nor Tempel addressed whether a taxpayer's expectation or receipt of a state or local tax credit may reduce a taxpayer's charitable contribution deduction under section 170, and therefore, these cases are not relevant for purposes of interpreting section 170.

Some commenters cited Arizona Christian School Tuition Organization v. Winn, 563 U.S. 125, 142-44 (2011), to support their position that the regulations should permit a full charitable contribution deduction when amounts are contributed to a charitable organization, even if the donor receives tax credits in return. While that case involved the types of contributions affected by the proposed regulations, the Court did not

address whether such contributions are deductible under section 170 or whether the contributors received a substantial benefit in exchange for their contributions.

b. Tax consequences of quid pro quo benefits

Some commenters pointed out that the proposed regulations failed to fully address the tax consequences of treating tax credits as quid pro quo benefits and suggested that additional guidance is needed. For example, commenters noted that the proposed regulations did not address the tax treatment of the sale, use, or lapse of the credits. In particular, commenters suggested that additional guidance may be needed to clarify application of the rules under sections 61, 164, 1001, and 1012 to the receipt, expectation of receipt, or use of tax credits. The Treasury Department and the IRS agree with commenters that additional guidance is necessary to address these complex issues.

Regarding the treatment of return benefits under section 164, the Treasury Department and the IRS issued Notice 2019-12 on **[Month DD]**, 2019. As discussed previously in this preamble, Notice 2019-12 provides a safe harbor under section 164 for an individual who itemizes deductions and who makes a payment to a section 170(c) entity in return for a state or local tax credit. The Treasury Department and the IRS will continue to consider comments regarding other tax consequences of treating tax credits as quid pro quo benefits and will provide additional guidance as needed.

c. Application of substance over form doctrine

Some commenters suggested that the proposed regulations should have relied in whole or in part on the substance over form doctrine rather than the quid pro quo principle. Under a substance over form approach, commenters explained, the proposed

regulations could treat contributions to funds established by state or local government entities in exchange for tax credits as, in substance, a payment of taxes to those government entities. These commenters stated that by relying on the substance over form doctrine, the proposed regulations could have been more easily tailored to address only those contributions paid to funds established to assist taxpayers in avoiding the limitation on state and local tax deductions. The commenters also stated that a focus on contributions to funds established by state and local government entities would more directly target the potential revenue loss.

The Treasury Department and the IRS have considered the substance over form doctrine in analyzing the proper tax treatment of contributions in exchange for tax credits, but have ultimately decided that, as a general matter, the application of the quid pro quo principle provides a more sound, comprehensive, and administrable approach. While a payment made to a state (or to an entity designated by the state) in exchange for a tax credit might in some circumstances seem similar to a payment of tax under section 164, the analysis raises additional issues and finds less support under other substance over form authorities. Specifically, this approach would result in the significant expansion in the definition of “tax” under section 164, would raise questions involving the proper timing of deductions for such payments, and would result in different treatments for similarly situated taxpayers. Furthermore, even if the substance over form doctrine were applied to treat payments or transfers to certain organizations as a payment of taxes, the proper treatment of these amounts under section 170, including the application of the quid pro quo principle, would continue to be relevant for taxpayers that make payments or transfers to certain charities in return for tax credits.

The Treasury Department and the IRS have determined that the tax laws and sound tax policy support the treatment of a state tax credit as a return benefit that reduces the amount of the taxpayer's charitable contribution deduction under section 170, regardless of whether the entity to which the contribution is made is controlled by a state or local government. The quid pro quo principle is applicable to contributions made to all types of donee entities. Section 170(c) provides an expansive list of the types of entities to which a taxpayer may contribute and receive a charitable contribution deduction. This list includes organizations controlled by state or local governments. If a contribution is made to or for the use of any such entity, the contribution may qualify as a charitable contribution, provided it meets all other requirements.

Moreover, a substance over form approach would not fully address concerns raised by commenters regarding state and local tax credit programs. Such programs can be used to generate tax benefits in excess of the amount the taxpayer contributes to the charitable organization, regardless of whether the contribution is made to an entity controlled by a state or local government. Finally, the Treasury Department and the IRS have serious concerns about the practicability of delineating clear and administrable criteria for distinguishing between state and local government entities and section 170(c)(2) organizations that are closely connected to state and local governments.

d. Quid pro quo provided by third party

Some commenters expressed a belief that under current law a quid pro quo received or expected to be received by a taxpayer does not reduce the taxpayer's

charitable contribution deduction if the quid pro quo comes from a party that is not the donee. Based on that belief, these commenters concluded that a tax credit from a state or local government should not reduce the charitable contribution deduction for a payment to a section 170(c)(2) organization. At least one commenter recommended that where contributions are made to section 170(c)(2) entities in exchange for tax credits provided by the state or local government, the benefit should be treated as income to the donor.

In support of this position, many commenters referred to §1.170A-1(h)(1) (payment in exchange for consideration) and §1.170A-13(f)(6) (defining “in consideration for” as a donee organization providing goods and services in consideration for taxpayer’s payment). One commenter expressed the view that the quid pro quo analysis cannot be applied to contributions to charitable organizations other than state or government entities because when a taxpayer makes a contribution to a charity, but receives consideration from a third party such as the state, the transaction cannot be characterized as a purchase. Commenters suggested that the language in the proposed regulations at §1.170A-1(h)(3)(iii) creating an exception from the “in consideration for” language of §1.170A-13(f)(6) for state or local tax credits provided by third parties is evidence that the proposed regulations depart from established law. Commenters suggested, as an alternative, that the final regulations set forth a general rule applying quid pro quo principles to benefits a taxpayer receives from any source, regardless of whether the benefits are provided by the donee or a third party. That rule would be applicable in determining if there is any quid pro quo under section 170 in all contexts, not just when a taxpayer receives state or local tax credits.

Section 1.170A-1(h)(1) provides that no part of a payment that a taxpayer makes to or for the use of an organization described in section 170(c) that is in consideration for (as defined in §1.170A-13(f)(6)) goods or services (as defined in §1.170A-13(f)(5)) is a contribution or gift within the meaning of section 170(c) unless the taxpayer (i) intends to make a payment in an amount that exceeds the fair market value of the goods or services; and (ii) makes a payment in an amount that exceeds the fair market value of the goods or services. Section 1.170A-1(h)(2) states that the charitable contribution deduction under section 170(a) may not exceed the amount of cash paid or the fair market value of property transferred to an organization over the fair market value of goods or services the organization provides in return. Section 1.170A-13(f)(5) defines goods or services as cash, property, services, benefits, and privileges, and §1.170A-13(f)(6) provides that a donee provides goods or services in consideration for a taxpayer's payment if, at the time the taxpayer makes a payment to the donee, the taxpayer receives or expects to receive goods or services in exchange for that payment.

The Treasury Department and the IRS acknowledge that the current regulations do not address situations in which the benefits a donor receives or expects to receive come from a third party. While the proposed regulations modify the existing regulations to address the specific case of payments in exchange for tax credits, the Treasury Department and the IRS intend to propose additional regulations setting forth a general rule for all benefits received or expected to be received from third parties, not just tax credits. In the interim, the final regulations regarding tax credits specify an exception to the existing definition of "in consideration for." However, the application of the quid pro

quo principle to benefits received or expected to be received from third parties is consistent with existing law.

In American Bar Endowment and Hernandez, the Supreme Court made clear that a payment is not a charitable contribution if the donor expects to receive a substantial benefit in return. American Bar Endowment, 477 U.S. at 116-17 (1986); Hernandez, 490 U.S. at 691-92. The source of the return benefit is immaterial from the donor's financial perspective. The quid pro quo principle is thus equally applicable regardless of whether the donor expects to receive the benefit from the donee or from a third party. In either case, the donor's payment is not a charitable contribution or gift to the extent the donor expects a substantial benefit in return.

The Supreme Court in American Bar Endowment and Hernandez did not directly address the question of third party benefits because the return benefits at issue in those cases were provided by the donees. The Court derived its quid pro quo principle in part from a lower court decision and a revenue ruling that had addressed the question. See American Bar Endowment, 477 U.S. at 117 (citing Singer, 449 F.2d 413 (Ct. Cl. 1971) and Rev. Rul. 67-246); Hernandez, 490 U.S. at 691 (citing Singer). In Singer v. United States, the appellate division of the Court of Claims (the predecessor to the Federal Circuit) held that a sewing machine company was not eligible for a charitable contribution deduction for selling sewing machines to schools at a discount because the company "expected a return in the nature of future increased sales" to students. Singer, 449 F.2d at 423-24. In so holding, the court expressly rejected the company's argument that this expected benefit should be ignored because it came from the students (i.e., third parties), rather than directly from the schools. Id. at 422-23. The

court stated, “Obviously, we cannot agree with plaintiff’s distinction.” *Id.* Similarly, in Rev. Rul. 67-246, Example 11, a local department store agreed to award a transistor radio, worth \$15, to each person who contributed \$50 or more to a specific charity. The ruling concluded that if a taxpayer received a \$15 radio as a result of a \$100 payment to the charity, only \$85 qualified as a charitable contribution deduction. It did not matter that the donor received the \$15 radio from the department store, a third party, rather than from the charity. This understanding guides the IRS’s audit practices. See IRS Conservation Easement Audit Techniques Guide (Rev. Jan. 24, 2018, p. 16) (stating that a “quid pro quo contribution is a transfer of money or property partly in exchange for goods or services in return from the charity or a third party”, and “a quid pro quo may be in the form of an indirect benefit from a third party”).

The Treasury Department and the IRS conclude that, under the most logical and consistent application of existing law, a charitable contribution deduction is reduced by any consideration a donor receives or expects to receive, regardless of whether the donee is the party from whom consideration is received or expected to be received. To conclude otherwise would provide incentives for taxpayers, charitable organizations, states, and localities to structure transactions involving third party benefits to bypass the requirements to reduce contribution deductions by the value of benefits received or expected to be received. Accordingly, the Treasury Department and the IRS do not adopt the recommendation of the commenters to limit application of the final regulations to circumstances in which a tax credit is provided by the donee, and as noted previously, the Treasury Department and the IRS intend to propose amendments to the

existing regulations to make clear that the quid pro quo principle applies regardless of whether the party providing the quid pro quo is the donee.

#### 4. Comments on Section 164(b)(6)

A number of commenters stated that the section 164(b)(6) limitation favors low-tax states, is a form of double taxation, or infringes on states' rights. These comments regarding the statutory limitation itself are beyond the scope of the proposed regulations.

#### 5. Conservation Easement Contributions

A large number of comments from conservation easement donors, land trusts, and government entities involved in conservation easement donations were specific to conservation easements. Conservation easement comments that relate to the applicability date of the regulations are addressed under the "Applicability Dates" heading later in this section.<sup>1</sup>

One group of comments relating to conservation easements expressed the view that donations of conservation easements to land trusts should be excluded from the rules in the final regulations because of the importance of land conservation, because Congress has provided extra incentives for contributions of conservation easements over the years, and because easement donations are not intended as section 164(b)(6) workarounds. The Treasury Department and the IRS recognize that conservation easements provide unique and perpetual benefits that are accorded favorable tax treatment by state governments as well as by Congress. Specifically, Congress treats deductions for conservation easement contributions more favorably than other

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<sup>1</sup> Although commenters used the term "effective date," it is clear that commenters were referring to the "applicability date" as the term is used herein.

charitable contribution deductions in some contexts, such as the percentage limitation and carryover rules.

The final regulations do not adopt this suggestion. These regulations are based on longstanding rules of general applicability relating to quid pro quo and charitable intent, and there is no authority under section 170 that would void the application of the quid pro quo principle and charitable intent doctrine to donors of conservation easements.

A second group of comments state that determining the value of a conservation easement tax credit may be difficult for donors and also for donees who prepare contemporaneous written acknowledgments. In at least one state, easement donors receive a property tax credit for each of the years that they continue to own the underlying property. Commenters stated that it is unknowable at the time of the donation how many years the donor would be eligible for the property tax credit or how to value a right to a tax credit that could continue many years into the future. Also, an expected credit may not necessarily be granted, may be granted in a subsequent tax year, may be subsequently reduced, or might never be used or transferred. The Treasury Department and the IRS understand that in some cases taxpayers may never receive the maximum credit. Nevertheless, it is well settled that an expectation of a return benefit negates the requisite charitable intent, and the regulations apply that rule. The final regulations at §1.170A-1(h)(3)(iv) state that the reduction in the amount treated as a charitable contribution is an amount equal to the maximum credit allowable that corresponds to the amount of the taxpayer's payment or transfer. If there is no

clear maximum credit allowable, taxpayers may reduce their charitable contribution deduction using a good faith estimate of the value of the credit.

A third group of comments noted that conservation easement donors who sell their credit should get basis in the credit equal to the amount of the reduction in the charitable contribution deduction. A number of states have conservation easement tax credit programs that allow the donor to sell the credit. Under existing case law, an easement donor has no gain or loss on receipt of a credit but recognizes capital gain upon its sale. See, for example, Tempel v. Commissioner, 136 T.C. at 354-55 (concluding that conservation easement donors had no basis in the tax credits that they sold). The Treasury Department and the IRS agree with this comment that this basis issue warrants additional consideration. Although the basis issue is beyond the scope of these regulations, the Treasury Department and the IRS intend to consider this issue for future guidance.

#### 6. Taxpayers at or Below the Section 164(b)(6) Limit

A number of commenters recommended that the Treasury Department and the IRS revise how the proposed regulations apply to taxpayers whose state and local tax deduction is at or below the \$10,000 limit in section 164(b)(6). Under the proposed regulations, a taxpayer who itemizes and is not subject to the alternative minimum tax (AMT), and whose state or local tax deduction is at or below \$10,000, may have adverse federal tax consequences. This taxpayer may have made a nondeductible contribution (in exchange for state or local tax credits) in lieu of a fully or partially deductible payment of state or local tax. Accordingly, some commenters recommended that taxpayers whose state and local tax liabilities fall at or below the \$10,000 limit be

allowed to deduct contributions made in exchange for state or local tax credits up to \$10,000. Some commenters recommended allowing these taxpayers to deduct the contributions only when the taxpayers' contributions are to the state (as opposed to an entity described in section 170(c)(2)). Other commenters recommended allowing the deduction only when the taxpayers' contributions are to a state or local tax credit program that was in existence as of December 22, 2017, the date of the enactment of the Act. Many commenters cited case law, legislative intent, and general principles of fairness. Several commenters suggested further study or exceptions for taxpayers with state and local tax liabilities below the \$10,000 limit. These commenters were concerned that the impact to these taxpayers may be greater than the Treasury Department forecasted. After considering these comments, the Treasury Department and the IRS published a notice of intent to propose regulations, Notice 2019-12, providing a safe harbor, as discussed previously in this preamble.

#### 7. Application of Section 162 for Business Taxpayers

Some commenters stated that business taxpayers are treated more favorably than others because business taxpayers may be able to claim deductions for payments to section 170(c) entities as ordinary and necessary business expenses under section 162. These commenters are correct that taxpayers engaged in a trade or business may be permitted a section 162 deduction for amounts paid to charitable organizations in some circumstances. See, for example, Marquis v. Commissioner, 49 T.C. 695 (1968) (taxpayer's cash payments to clients that were charitable entities furthered her travel agency business and were therefore not subject to the limitations of section 170).

However, some commenters raised questions regarding whether a payment for a tax credit would always bear a direct relationship to a taxpayer's business.

A few commenters opined that the proposed regulations further escalate the disparate treatment of charitable contributions by individual wage earners as compared to similar contributions by passthrough entities and their members who are individuals. These commenters noted that the limitation imposed by section 164(b)(6) does not apply to state or local real or personal property taxes paid or accrued in carrying on a trade or business or an activity described in section 212. As a result of this exception to the limitation under section 164 and the availability of business expense deductions under section 162, commenters stated that a taxpayer-owner of a passthrough entity will continue to receive the benefits of an allocable share of tax credits received by the passthrough entity. In addition, commenters pointed out that several states have enacted or considered enacting legislation that shifts state taxes from individuals to passthrough entities and entitles the owners to claim a credit on the owner's state tax return for the amount of the owner's distributive share of taxes paid by the passthrough entity.

The proposed and final regulations apply to charitable contributions by business taxpayers. Specifically, a business taxpayer, like an individual taxpayer, must reduce the charitable contribution deduction by the amount of any return benefit received or expected to be received. Thus, the commenters' concerns do not result from disparate treatment of business taxpayers under section 170, but rather result from the application of sections 162 and 164, including application of the limitation under section 164(b)(6) to passthrough entities and their owners. The Treasury Department and the IRS

recognize that the final regulations may raise additional questions regarding the application of sections 162 and 164 to business entities that make payments to section 170(c) entities and that receive or expect to receive state or local tax credits in return for such payments. In response to these questions, the Treasury Department and the IRS published Rev. Proc. 2019-12, as previously discussed in this preamble, which provides safe harbors under section 162 for certain payments made by C corporations or specified passthrough entities. Neither the final regulations nor the safe harbors in the revenue procedure otherwise affect the availability of a business expense deduction under section 162 for payments that are ordinary and necessary expenses incurred in carrying on a trade or business. The Treasury Department and the IRS will continue to study comments involving the effect of the final regulation on various business entities and will provide additional guidance as needed.

#### 8. Disclaiming the Tax Credit

If a taxpayer properly declines receipt of a benefit, the taxpayer will not be treated as receiving or expecting to receive the benefit, and the charitable contribution deduction will not be reduced by the amount of the benefit. See Rev. Rul. 67-246, 1967-2 C.B. 104, 108, Example 3 (taxpayer who wants to support charity, but does not intend to use the ticket offered in return for his donation, may refuse to accept the ticket and receive a charitable contribution deduction unreduced by the value of the ticket). A number of commenters asked for guidance on how a taxpayer may decline receipt of state or local tax credits. Although not specifically stated in the regulations, taxpayers who prefer to claim an unreduced charitable contribution deduction have the option of not applying for a state or local income tax credit where such an application is required

in order to receive the credit. Alternatively, taxpayers may apply for a lesser amount of the credit. The Treasury Department and the IRS request comments as to how taxpayers may decline state or local tax credits in other situations.

#### 9. Cliff Effect of the 15-Percent Exception

The proposed regulations include an exception under which a taxpayer may disregard a state or local tax credit if the credit does not exceed 15 percent of the taxpayer's payment or 15 percent of the fair market value of the property transferred by the taxpayer. A number of commenters stated that the 15-percent exception results in an unfair "cliff effect" because credits above 15 percent do not receive the benefit of this exception. The commenters note that this unfairness is most significant where credits only exceed 15 percent by a small amount. A number of commenters suggested that an amount equal to the first 15 percent of all credits should be disregarded. Commenters also noted that the proposed regulations penalized donors of smaller amounts because 15 percent of a large payment results in a much larger amount covered by the exception than 15 percent of a small payment. Commenters also noted that a 15-percent exception would typically permit a deduction for an amount that is more than the amount treated as de minimis under the rules of section 170. See, for example, Rev. Proc. 90-12, 1990-1 C.B. 471 (providing guidelines for determining whether the provision of small items or benefits of token value in return for a contribution have insubstantial value such that the contribution is fully deductible under section 170). On the other hand, some commenters requested that a higher percentage be treated as de minimis.

The suggestion to disregard an amount equal to 15 percent of the donor's transfer or otherwise change the 15-percent exception was not adopted. The 15-percent exception was designed to provide consistent treatment for state or local tax deductions and state or local tax credits that provide a benefit that is generally equivalent to a deduction. The 15-percent exception is intended to reflect the combined benefit of state and local tax deductions, that is, the combined top marginal state and local tax rates, which the Treasury Department and the IRS understand currently do not exceed 15 percent. The Treasury Department and the IRS considered tailoring this exception to the combined marginal state and local tax rates applicable for a taxpayer's particular jurisdiction. The Treasury Department and the IRS determined that using a single rate sufficient to cover the highest existing marginal rates would avoid the complexity and burden that would arise if a taxpayer had to compute the sum of the taxpayer's state and local marginal tax rates to determine whether the tax credit received exceeded the benefit that the taxpayer would have received as a deduction. The exception ensures that taxpayers in states offering state tax deductions and taxpayers in states offering economically equivalent credits are treated similarly. This exception is not intended to be an application of the de minimis standard for insubstantial or inconsequential benefits under Rev. Proc. 90-12, 1990-1 C.B. 471.

#### 10. Application to State and Local Tax Deductions

Some commenters expressed concern that the proposed regulations do not apply the quid pro quo analysis to state and local tax deductions. These concerns reflect the view that the quid pro quo analysis under section 170 is equally applicable to tax benefits in the form of state or local tax deductions as it is to state or local tax

credits. As noted in the preamble to the proposed regulations, the Treasury Department and the IRS believe that considerations of tax policy and sound tax administration do not support the application of quid pro quo principles in the case of dollar-for-dollar state or local tax deductions. The economic benefit of a dollar-for-dollar deduction is limited because it is based on a taxpayer's state and local marginal rate. Therefore, the risk of a taxpayer using such deductions to circumvent section 164(b)(6), and the potential revenue loss, is comparatively low. This is true even in high tax states. In addition, if state and local tax deductions for charitable contributions were treated as return benefits, it would make the accurate calculation of federal taxes and state and local taxes difficult for both taxpayers and the IRS. For example, the value of a deduction would vary based on the taxpayer's marginal state and local tax rates, making for more complex computations and adding to administrative and taxpayer burden. Also, many states use federal taxable income as the starting point for computing state taxable income, and the amount reported as a charitable contribution deduction on a taxpayer's federal tax return is typically the amount of the deduction on the taxpayer's state tax return. Allowing an unreduced federal charitable contribution deduction even though a state provides a similar deduction in measuring state taxable income would avoid administrative complications. Accordingly, a dollar-for-dollar state or local tax deduction does not raise the same concerns as a state or local tax credit, and it would produce unique complications if it were to be subject to the quid pro quo principle. Thus, the final regulations allow taxpayers to calculate their federal tax deductions without regard to their dollar-for-dollar state and local tax deductions. However, the Treasury Department and the IRS are concerned that the granting of state or local tax deductions

in excess of the amounts paid or the fair market value of property transferred to an entity described in section 170(c) could result in more substantial economic benefits to the taxpayer and should be treated as a quid pro quo. Accordingly, the final regulations also retain the exception to general rule for excess state or local tax deductions.

Some commenters also contended that the proposed regulations disfavor state and local governments relative to the federal government. These commenters noted that the proposed regulations do not require a taxpayer to reduce the taxpayer's charitable contribution deduction by the value of the federal tax deduction. However, as discussed in the prior paragraph, the final regulations do not treat state charitable contribution deductions any differently than federal charitable contribution deductions. Under the final regulations neither state nor federal charitable contribution deductions are treated as return benefits in determining the taxpayer's charitable contribution deduction under section 170. The economic benefit of a state or federal charitable contribution deduction is limited because both are based on a taxpayer's marginal tax rate. In addition, there is minimal risk that a taxpayer will use either of these deductions to circumvent section 164(b)(6), and the potential revenue loss, in both cases, is comparatively low. Furthermore, unlike state or local governments, Congress would not be motivated to enact a provision enabling an excess charitable contribution to circumvent its other federal tax laws. Thus, the final regulations specifically address the workarounds stemming from taxpayer's use of state and local tax credit programs, but continue to provide parallel treatment of both federal and state charitable contributions deductions.

#### 11. Contributions to Foreign Charitable Organizations

A small number of commenters expressed the view that the proposed regulations favor payments to foreign charities. Charitable contributions made to foreign organizations generally are not deductible for federal income tax purposes. See section 170(c)(2). Moreover, in the limited situations where these deductions are allowed, taxpayers are treated as if they are making such contributions to entities that are organized in the United States, and accordingly, such contributions would be subject to the rules and regulations under section 170. As a result, while tax credits provided by foreign governments for contributions to foreign charities are outside the scope of the final regulation, if the taxpayer is seeking to deduct such charitable contributions under section 170, the quid pro quo principle set out under section 170 would be equally applicable.

## 12. Valuation and Substantiation of the Credits

Commenters expressed concerns about the challenges for taxpayers and donees in determining the value of a state or local tax credit. Under the proposed regulations, a taxpayer needs to know the “maximum credit allowable” that corresponds to the amount of the taxpayer’s transfer to the donee. This amount would typically be the stated amount of the credit, and unless the 15-percent exception applies, the taxpayer’s charitable contribution deduction would generally be reduced by this amount. However, if the credit does not have a clear maximum credit allowable, a taxpayer’s good faith estimate of the value will satisfy the rules of the final regulations.

Commenters have also expressed concerns about substantiation of a charitable contribution when the donee does not know whether the donor expects to receive a state or local tax credit. If a donee is not the entity providing the credit, the

contemporaneous written acknowledgment rules do not require that the amount of the credit be reported in the acknowledgment. See section 170(f)(8) (stating that a contemporaneous written acknowledgment includes a statement of whether the donee provided goods and services and if so, includes a good faith estimate of the value of those goods or services). Further, under §1.170A-13(f)(5), goods and services include benefits.

One commenter asked about compliance with section 6115, which generally requires donee disclosures in connection with quid pro quo contributions (as defined in section 6115(b)), and specifically requires section 170(c) organizations (but not section 170(c)(1) entities) to provide donors with a good faith estimate of the value of goods or services they provide. If a section 170(c)(2) organization is not providing the state or local tax credit to the donor, section 6115 does not apply. Accordingly, there is no section 6115 requirement for section 170(c)(2) organizations to disclose information about a tax credit provided by a state or local government.

### 13. Regulatory Flexibility Act

Some commenters stated that the Regulatory Flexibility Act (5 U.S.C. chapter 6) (“RFA”) applies to the regulations because small tax-exempt organizations and small governmental jurisdictions would be affected by the proposed regulations due to a potential reduction in contributions. These commenters recommended that the final regulations contain a RFA analysis. Other commenters noted that some donors may be small entities affected by the regulation. The Treasury Department and the IRS do not agree that a RFA analysis is required. The organizations and small governmental jurisdictions that receive deductible contributions as part of a state or local tax credit

program are not subject to the proposed regulations, and any potential effect on contributions to these organizations is an indirect effect of the regulation. The RFA does not apply to entities indirectly affected by the regulation. See, for example, Cement Kiln Recycling Coalition v. EPA, 255 F.3d 855, 868 (D.C. Cir. 2001); Mid-Tax Elec. Coop v. FERC, 773 F.2d 327 (D.C. Cir. 1985). For small entities that are donors, and potentially subject to the regulations, the regulations do not impose more than nominal costs and do not impose a collection of information requirement.

#### 14. Concerns About Reduced Charitable Giving

A large number of commenters expressed concern that the proposed regulations would result in an overall decline in charitable giving. Many of the commenters expressed concern about the impact of the regulations on particular charities or types of charities. A large number of comments were received on tax credit programs that encourage contributions to organizations that help fund public and private school programs. A number of commenters were concerned that the proposed regulations would decrease education opportunities for impoverished and special needs children in grades K-12. Some commenters suggested that the final regulations apply only to contributions to governments or government entities and not to private school organizations, while others suggested postponing the applicability date of final regulations to allow time to study the effects on scholarship granting organizations. A few commenters expressed a concern that the proposed regulations may result in a decrease in donations to scholarship granting organizations and increase the burden on public schools, given that private schools may not be able to provide as many scholarships to low-income students. Other commenters expressed concern that some

state or local tax credit programs unfairly incentivize contributions to private organizations, thus diverting resources from public functions, such as public schools.

Other commenters recommended that donations of conservation easements should be exempted from the rules in the regulations. Commenters representing land trusts expressed concern that the regulations would reduce the number of donated conservation easements, thereby reducing the ability of the federal government, state and local governments, and land trusts to conserve in perpetuity significant natural lands, water, and habitats. A commenter noted the needs of struggling farmers and other landowners who might not be able to afford to donate a conservation easement without a state tax credit. Some commenters observed that because of the significance of land conservation, Congress has already provided special incentives for conservation easement donations under section 170, and the commenters suggested the Treasury Department and the IRS follow Congress's lead by making an exception in the final regulations for donations of conservation easements.

Commenters from health care organizations, such as rural hospital foundations, expressed concern that the proposed regulations would reduce charitable giving for health care, reducing the ability of health care organizations to offset rising medical costs and declining patient revenue. Other commenters expressed concerns that the proposed regulations would undermine state programs that offer tax credits for contributions supporting a variety of local initiatives, including public arts, education, health, human services, environment, enterprise zones, and community betterment. Other commenters were concerned about the effect of the regulations on child care programs. A few commenters opined that the proposed regulations would further strain

state and local finances that are already adversely impacted by the new limitation on deductions of state or local taxes. The commenters stated that the new limitation would potentially force states and localities to confront difficult choices regarding tax rates and public services. In addition, several commenters suggested that the Treasury Department and the IRS adopt a facts-and-circumstances test to differentiate between tax credit programs that are consistent with state and federal policy goals and those that are designed for tax avoidance.

The Treasury Department and the IRS recognize the importance of the federal charitable contribution deduction, as well as state tax credit programs, in encouraging charitable giving. The final regulations continue to allow a charitable contribution deduction for the portion of a taxpayer's charitable contribution that is a gratuitous transfer, and the regulations also leave unchanged the state-level benefit provided by state tax credits. In combination with Notice 2019-12, the regulations will not alter the charitable giving incentives for the overwhelming majority of taxpayers as compared to the incentives under federal tax law prior to enactment of section 164(b)(6). As discussed previously in this preamble, Notice 2019-12 provides a safe harbor for certain individual taxpayers who itemize deductions and who make payments to a section 170(c) entity in return for a state or local tax credit. Under the safe harbor, these individuals may treat the portion of such payment that is or will be disallowed as a charitable contribution deduction under section 170 as a payment of state or local tax for purposes of section 164. Notice 2019-12 will mitigate the impact of the final regulations on state or local tax credit programs that incentivize giving to all section 170(c) entities, including entities supporting educational scholarship programs, child

care, public health, and other important goals. Thus, the impact on taxpayers' choices will be small.

The final regulations apply longstanding principles regarding charitable intent and quid pro quo, and therefore treat all contributions to entities described in section 170(c) similarly. Those principles apply equally to all charitable contributions, regardless of the charitable purpose or type of donee. Accordingly, the final regulations do not adopt a facts-and-circumstances test or a test based on the type of section 170(c) organization.

#### 15. Programs in Existence Before the Act

A large number of commenters suggested that the final regulations exempt tax credit programs that were established before the date of the enactment of section 164(b)(6). The commenters noted that the pre-existing programs could not have been intended as section 164(b)(6) workarounds. Other commenters explained that many taxpayers made payments or transfers to existing programs in anticipation of receiving state or local tax credits as well as deductions, and the regulations would cause financial hardships. Further, some commenters expressed an opinion that the regulations are politically motivated, allegedly targeting states and localities with high tax rates. Commenters also stated that exempting pre-existing programs would not lead to an unanticipated revenue loss because revenue implications were known when the Act was enacted.

The regulations are based on longstanding federal tax law principles that apply equally to all taxpayers. To ensure fair and consistent treatment, the final regulations do not distinguish between taxpayers who make transfers to state and local tax credit programs enacted after the Act and those who make transfers to tax credit programs

existing prior to the enactment of the Act. Neither the intent of the section 170(c) organization, nor the date of enactment of a particular state tax credit program, are relevant to the application of the quid pro quo principle. Accordingly, the final regulations apply the rules equally to all state and local tax credit programs, and the final regulations do not adopt commenter recommendations to create exceptions to the general rule for various types of state tax credit programs.

Regarding the comment on revenue implications for pre-existing programs, state and local governments have the ability to change the parameters, including the aggregate dollar amount of credits, of these programs. In addition, as noted previously, some states and taxpayers have pursued tax planning strategies through the use of pre-existing state or local tax credit programs that would have the effect of allowing taxpayers to deduct their payments of state and local taxes in excess of the limitation under section 164(b)(6). These strategies would increase the revenue loss to the federal government beyond estimates when the Act was enacted.

#### 16. Applicability Date

A number of commenters requested a delayed applicability date, or in the alternative, a phased-in implementation of the proposed regulations. The majority of these commenters requested an applicability date of January 1, 2019. Others suggested dates of up to five years after the enactment of the Act, and still others did not propose a specific date. Some commenters requested a delayed applicability date with respect to all tax credit programs, while others requested a delayed applicability date for only certain tax credit programs.

Many commenters requesting a delayed applicability date expressed concern about the adverse impact on state scholarship tax credit programs. Some commenters noted that a phased-in implementation or delayed applicability date may minimize uncertainty for students. Commenters also described the application process for certain state tax credit programs, requesting a delayed applicability date of October 31, 2018, or December 31, 2018, to ensure that states would have sufficient time to inform applicants as to whether their applications were accepted, and to provide applicants with sufficient time to make contributions prior to the date of applicability of the proposed regulations.

Some commenters requested a delayed applicability date of January 1, 2019 or 2020, for conservation easement donations. These commenters stated that donations of conservation easements are unique in that they are time-consuming and costly for donors to plan for and finalize. For example, a conservation easement donor may have to expend tens of thousands of dollars to hire an appraiser, an attorney, a surveyor, and in some jurisdictions, pay an application fee. Also, it takes many months, sometimes more than a year, for the donor to take all the necessary steps to contribute an easement that is deductible under section 170(h) and also creditable under state law, and many easements are donated at the end of the calendar year. The commenters stated that the mid-year applicability date in the proposed regulations has created complexity for taxpayers.

These suggestions were not adopted. The Treasury Department and the IRS continue to believe that the proposed applicability date of August 27, 2018, provides maximum certainty for taxpayers making contributions in exchange for state and local

tax credits and minimizes revenue loss. If the proposed applicability date had not been contemporaneous with the proposed regulations, the Treasury Department and the IRS believe that taxpayers would have engaged in significant tax planning in advance of the regulations being finalized, resulting in a significant loss of revenue. Additionally, Notice 2018-54, released May 23, 2018, gave taxpayers timely notice that formal guidance was forthcoming. It would be inequitable to revise the applicability date at this point, as some taxpayers have made decisions regarding their charitable contributions based on the applicability date in the proposed regulations. Finally, any delay in applying the rules of the final regulation would potentially undermine the purposes of the limitation in section 164(b)(6).

### **Special Analyses**

Executive Orders 12866 and 13563 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility. This rule has been designated as subject to review under Executive Order 12866 (EO 12866) pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations. OMB has determined that the rule is economically significant and therefore subject to review under section 1(c) of the Memorandum of Agreement (MOA). Elsewhere in the Special Analyses, the economic effects of the rule are analyzed in conjunction with Notice 2019-

12, which provides a safe harbor that taxpayers may immediately rely upon and that likely diminishes the effects of the rule. OMB has made its determination based only on the economic effects of the rule. This rule is a regulatory action under Executive Order 13771.

The following analysis provides further detail regarding the anticipated impacts of the rule. Part I explains the need for the rule. Part II specifies the baseline for the economic analysis. Part III summarizes the economic effects of the rulemaking, relative to this baseline. Part IV provides illustrative scenarios. Part IV.A describes the tax effects of charitable contributions prior to enactment of the statutory limitation on deductions for state and local taxes under section 164(b)(6) (the “SALT limitation”) in the Act. Part IV.B provides examples comparing the tax effects of charitable contributions after enactment of the SALT limitation, but absent the rule (the baseline) to the tax effects under the rule and notice. Finally, Part V provides a qualitative assessment of the potential costs and benefits of the rule and notice compared to the baseline.

#### I. Need for Regulation

This regulation provides guidance on the deductibility of charitable contributions when a taxpayer receives or expects to receive a corresponding state or local tax credit. The regulation is intended to clarify the relationship between the federal charitable contribution deduction under section 170 and the recently-enacted SALT limitation. Compelling policy considerations reinforce the interpretation and application of section 170 in this context. Disregarding the value of state and local tax credits received or expected to be received in return for charitable contributions would precipitate revenue

losses that would undermine the limitation on the deduction for state and local taxes adopted by Congress under the Act.

In this regard, the Treasury Department and the IRS note that the Joint Committee on Taxation (JCT) estimated that the limitation on state and local tax deductions along with certain other reforms of itemized deductions would raise \$668 billion over ten years. See Joint Committee on Taxation, “Estimated Budget Effects of the Conference Agreement for H.R. 1, The ‘Tax Cuts and Jobs Act,’” JCX-67-17, December 18, 2017, at <https://www.jct.gov/publications.html?func=startdown&id=5053>. A substantial amount of this revenue would be lost if state tax benefits received in exchange for charitable contributions were ignored in determining the charitable contribution deduction. This estimate is not a revenue estimate of the rule, in part because it includes other reforms of itemized deductions but does not reflect certain other provisions of the Act. In addition, this does not represent an estimate of the non-revenue economic effects of the rule. Still, the JCT estimate provides a rough upper bound of the potential revenue loss and individual contribution choices at stake in this rulemaking.

## II. Baseline

Prior to the proposed and final regulation, the Treasury Department and the IRS had not issued formal guidance on the deductibility of contributions to entities described in section 170(c) that give rise to state or local tax credits. There was also no guidance, aside from Notice 2018-54, addressing the interaction between section 170 and the newly enacted SALT limitation. As a result, there was a degree of taxpayer uncertainty as to whether state and local tax credits were a return benefit that reduces a taxpayer’s

charitable contribution deduction, and absent further guidance, taxpayers would likely have taken different filing positions. For informational and analytical purposes, however, this analysis assumes as a baseline that state and local tax credits are generally not treated as a return benefit or consideration and therefore do not reduce the taxpayer's charitable contribution deduction under section 170(a). The illustrative scenarios presented below make use of alternative baseline scenarios to provide clarity on the incremental impacts arising out of the rule and notices.

### III. Summary of Economic Effects

Section 2 of the MOA stipulates that tax regulations that are likely to have a non-revenue effect on the economy of \$100 million or more (identified in section 1(c) of the MOA) will be subject to the analytical requirements applicable to significant regulations under section 6(a)(3)(B) of EO 12866, as well as the additional requirements applicable to economically significant regulations under section 6(a)(3)(C) of EO 12866. Those requirements entail an assessment of potential costs and benefits of significant regulatory actions. Section 6(a)(3)(C) of EO 12866 also states that to the extent feasible, quantitative assessments including the underlying analyses for a non-inclusive list of factors shall be provided for the costs and benefits of rules that have an annual effect on the economy of \$100 million or more or adversely affect in a material way the economy or certain aspects of the economy.

At the proposed rule stage, the Treasury Department and the IRS determined that the proposed rulemaking would not result in costs, benefits, or non-revenue transfers in excess of \$100 million per year, and thus would not be economically significant. However, the Treasury Department and the IRS acknowledge that there is

limited quantitative data available for purposes of evaluating economic effects. Given the level of public interest and engagement, and possible economic and/or behavioral impact, including to individuals' contribution choices, beyond what can be reasonably anticipated with quantitative methods and available data, the final rule has been designated by OMB as economically significant, and it is therefore subject to the analytical requirements for an economically significant rule.

The Treasury Department and the IRS note, however, that the non-revenue impacts of the final rule could be below the economically significant threshold, especially when the potential effects are considered in conjunction with Notice 2019-12, which is to be issued with the final rule. The requirements in the Notice have not been finalized or incorporated into this final rulemaking, but as noted earlier in this preamble, the Treasury Department and the IRS anticipate issuing a proposed rule formalizing the guidance in the Notice shortly after this final rule is issued.

The Treasury Department and the IRS expect that the main effect of this rulemaking with Notice 2019-12 would be to reduce the incentive for individual taxpayers to reallocate state and local taxes from general public funds to funds designated for specific public purposes, solely to generate a charitable gift for federal tax purposes. These transfers from one public fund to another would not be substantive in nature and therefore are not anticipated to generate real economic effects. The rulemaking with Notice 2019-12 would also increase compliance and administrative costs for some taxpayers and charitable entities but decrease them for others. As discussed in Part V of the Special Analyses, the Treasury Department and the IRS expect these effects are likely small and, on net, expect a reduction in compliance

burdens (because fewer transactions performed solely for tax avoidance will be undertaken).

The rulemaking with Notice 2019-12 may also marginally reduce the incentive to make contributions to charitable organizations that result in state and local tax credits, which may have the effect of reducing aggregate contributions. But the Treasury Department and the IRS expect this effect to be small. For example, for an individual taxpayer who claims itemized deductions on a Federal income tax return, has more than \$10,000 of state and local tax liability, and has a Federal marginal tax rate of 24%, a \$1,000 contribution to an organization described in section 170(c) that gives rise to a dollar-for-dollar state tax credit in exchange for the contribution yields a combined \$1,240 of tax benefits under the baseline (\$240 from the deduction under section 170(a) and \$1,000 from the state tax credit). Under the rulemaking with Notice 2019-12, the same \$1,000 contribution yields only \$1,000 in tax benefits. A substantial incentive to give to the organization still exists (as the cost of giving is \$0), though that incentive is reduced because of the rulemaking.

In addition, the direct incentive to make contributions to organizations that do not give rise to state or local tax credits is unchanged by the rulemaking with Notice 2019-12. The reduction in the relative benefit of contributing to organizations that result in state or local credits might induce some taxpayers to contribute to other organizations instead. However, this effect may be modest because the tax benefit of donating to an organization eligible for a large state tax or local credit is still greater than the benefit of donating to another charitable organization. (See column A versus column B for each example in Table 1.) Moreover, transfers between similar charitable organizations (or

between the state and a charitable organization generating a state or local tax credit) might have little or no effect on the ultimate beneficiaries of the charitable organizations or on consumers of public goods.

As noted earlier, EO 12866 calls for quantitative analysis to the extent feasible. One commenter to the proposed regulations also stated that the analyses should have included quantitative estimates of the costs and benefits of the rule, including estimates of the potential size of state and local tax credits, federal revenue losses, and efficiency losses. The commenter further stated that without quantitative estimates it is not known “whether the potential problem is significant enough to justify this change in tax regulations.”

The Treasury Department and the IRS provide in this Special Analyses an economic analysis, including to the extent feasible, quantitative estimates that offer context regarding the scope of possible impacts arising out of these final regulations. In particular the Treasury Department and the IRS provide examples of how different types of taxpayers would or would not be affected by this rulemaking as well as estimates of the shares of taxpayers potentially affected by the rulemaking with Notice 2019-12. However, because taxpayers do not report whether a charitable donation has given rise to a state or local tax credit, the extent to which states would create new tax credit programs and taxpayers would make contributions to such programs under the baseline or regulations is uncertain, and the extent to which the welfare of the ultimate beneficiaries of such charitable contributions or state spending is uncertain, the Treasury Department and the IRS have not quantified the non-revenue economic effects of the rule.

#### IV. Illustrative Scenarios<sup>2</sup>

For the following illustrative scenarios, assume the following facts: Charitable organizations A and B are entities described in section 170(c) and are equally efficient in providing similar public goods. Contributions to charity A are eligible for a dollar-for-dollar state tax credit. Contributions to charity B are ineligible for this credit but are deductible from state taxable income. The taxpayer itemizes deductions, and these itemized deductions in aggregate are at least \$1,000 more than the standard deduction. The taxpayer has the choice to contribute \$1,000 to charity A, and this \$1,000 contribution generates a state tax credit of \$1,000.<sup>3</sup> That is, the tax credit is dollar-for-dollar but does not otherwise figure into the calculation of the taxpayer's state tax liability. The taxpayer has more than \$1,000 of state tax liability, so that the taxpayer's state tax liability is reduced by the entire \$1,000 of the state tax credit. Finally, if the taxpayer makes the \$1,000 contribution that generates a state tax credit of \$1,000, the taxpayer reduces by \$1,000 the withholding and payments of state tax during the taxable year in question. The state tax liability is therefore reduced by the full amount of the state tax credit in the same taxable year as the contribution is made.<sup>4</sup> Further assume a taxpayer is in the 24 percent federal tax bracket, itemizes federal tax

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<sup>2</sup> While the illustrative scenarios and the analysis that follow focuses on individual taxpayers, the final regulations also apply to business taxpayers. Businesses making payments to entities described in section 170(c), however, may deduct certain of these payments as ordinary and necessary business expenses under section 162. In addition, Rev. Proc. 2019-12, 2019-04 I.R.B. 401, provides safe harbors under section 162 for certain payments by businesses. Therefore, the Treasury Department and the IRS expect that few business donors would be impacted by the final regulations.

<sup>3</sup> Note that this analysis only addresses state tax credits offering a 100% benefit. The results may differ for credits offering a lower benefit, but the comparative results of the illustrative examples would be similar.

<sup>4</sup> The results of the examples are generally unchanged if the taxpayer instead receives the credit as a refund of state taxes paid that were deducted from federal taxable income, as such refund would be includible in federal taxable income in the following year.

deductions, and has a state tax rate of 5 percent. If the taxpayer is subject to the AMT, assume an AMT marginal tax rate of 26 percent.

The Act, this rule, and the safe harbor for certain individuals described in Notice 2019-12 alter the incentives some taxpayers face about whether and how much to give to organizations that receive charitable contributions, as well as to which organizations. This is illustrated in the following scenarios, which are also summarized in Table 1.

A. Prior law: Section 170 Charitable Contributions Prior to the Act

The tax effects of contributions prior to enactment of the Act are illustrated in the columns labeled “Prior Law” in Table 1.

1. Taxpayer not subject to the AMT

Prior to enactment of the Act, if the taxpayer made a \$1,000 contribution to charity A that generated a state tax credit of \$1,000, the deduction for charitable contributions under section 170(a) increased by \$1,000, and the taxpayer’s liability for state and local taxes deductible under section 164 decreased by \$1,000. The taxpayer’s itemized deductions, taxable income, and federal tax liability were unchanged from what they would have been in the absence of the contribution.<sup>5</sup> The taxpayer’s state tax liability decreased by \$1,000 because of the state tax credit. The combined federal and state tax benefits of the \$1,000 contribution were therefore \$1,000, and the cost to the taxpayer and to the federal government of making the contribution was \$0. This is shown in column A under Prior Law for Example 1 in Table 1 and replicated in the same column for Example 2.

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<sup>5</sup> This assumes the taxpayer was not subject to limitations such as the overall limitation on itemized deductions under section 68 or subject to a percentage limitation for the deduction under section 170, an assumption that is maintained throughout the succeeding discussion.

## 2. Taxpayer subject to the AMT

If the taxpayer were subject to the AMT under section 55, however, there was a net benefit to the taxpayer from contributions to charity A, which provided state tax credits. State and local taxes are not deductible in determining taxable income under the AMT, but charitable contributions are deductible in determining taxable income under the AMT. If the taxpayer contributed \$1,000, taxable income under the AMT was reduced by \$1,000 due to the charitable contribution deduction under section 170, but there was no corresponding reduction in the deduction for state and local taxes. Under an AMT marginal tax rate of 26 percent, the federal tax benefit of this \$1,000 contribution would be \$260. Because of the dollar-for-dollar state tax credit, the taxpayer received a combined federal and state tax benefit of \$1,260 for a \$1,000 contribution; that is, the taxpayer received \$260 *more* in tax benefits than the amount of the contribution. This is shown in column A under Prior Law for Example 3 in Table 1.

## 3. Comparison of contributions to different organizations under prior law

In combination, state and federal tax laws generally provide a greater incentive to contribute to organizations eligible for state tax credits (charity A) than to other organizations (charity B). The effects of a contribution to charity A are described in Parts IV.A1 and IV.A2 previously.

Prior to enactment of the Act, for a taxpayer not subject to the AMT, a \$1,000 contribution to charity B yielded a smaller combined federal and state tax benefit than to charity A. The state tax benefit was \$50 (\$1,000 multiplied by the 5 percent state tax rate). The taxpayer's itemized deductions at the federal level increased by \$950 (the \$1,000 charitable contribution deduction less the \$50 reduction in state taxes paid).

The federal tax benefit of this increase was \$228 (\$950 multiplied by the 24 percent federal tax rate), resulting in a combined federal and state tax benefit of \$278. The net cost to the taxpayer of the \$1,000 contribution was \$722. This is shown in column B under Prior Law for Example 1 in Table 1 and replicated in the same column for Example 2.

For a taxpayer subject to the AMT, a \$1,000 contribution to charity B yielded a combined federal and state benefit of \$310—the \$1,000 contribution multiplied by the taxpayer’s marginal tax rate under the AMT of 26 percent, or \$260, plus the value of the deduction from state tax, or \$50 (\$1,000 multiplied by the 5 percent state tax rate). The net cost to the taxpayer of the \$1,000 contribution was \$690. This is shown in column B under Prior Law for Example 3 in Table 1.

Contributing to either charity A or charity B reduced the taxpayer’s combined federal and state tax liability, but the existence of the state tax credit for contributions to charity A made contributions to that organization more attractive. This is seen by comparing the Total Tax Benefit in column A under Prior Law to the corresponding value in column B for each of the three examples. For taxpayers not subject to the AMT, contributions to charity A yielded a combined federal and state tax benefit of \$1,000, compared to a combined federal and state tax benefit of \$278 for a contribution to charity B. The AMT increased the disparity for contributions to charity A versus charity B, resulting in a combined federal and state tax benefit of \$1,260 for a contribution to charity A versus \$310 for a contribution to charity B.

B. Examples of current law and practices under the Act and final rule with Notice 2019-

The enactment of the SALT limitation in the Act has, in limited circumstances, altered the federal tax effects of charitable contributions as described in the following examples. These are illustrated in the columns labeled “Baseline” and “Final Rule with Notice 2019-12” in Table 1.

1. Example 1: Taxpayer is above the SALT limitation and not subject to the AMT

a. Baseline

If a taxpayer who has a state tax liability of more than \$1,000 above the SALT limitation and is not subject to the AMT makes a \$1,000 contribution to charity A, the deduction for charitable contributions under section 170(a) increases by \$1,000, but the deduction for state and local taxes paid under section 164 is unchanged.

Consequently, itemized deductions increase by \$1,000, and taxable income decreases by \$1,000. If the taxpayer is in the 24 percent bracket, federal liability will decrease by \$240, and state tax liability will decrease by the \$1,000 state tax credit. The combined federal and state tax benefits of the \$1,000 contribution are therefore \$1,240, and the taxpayer receives a \$240 net benefit while the federal government has a loss of \$240. This is shown in column A under Baseline for Example 1 in Table 1.

b. Final Rule with Notice 2019-12

If the same taxpayer makes the \$1,000 contribution to charity A under the rule with Notice 2019-12, the entire \$1,000 contribution is not deductible under section 170(a), and the deduction for state and local taxes paid under section 164 is unchanged due to the SALT limitation. The taxpayer’s itemized deductions, taxable income, and federal tax liability are unchanged from what they would be in the absence of the contribution. The taxpayer’s state tax liability decreases by \$1,000 because of the state

tax credit. The combined federal and state tax benefits of the \$1,000 contribution are therefore \$1,000, or \$240 less than under the baseline. This is shown by comparing the Total Tax Benefit in column A under Final Rule with Notice 2019-12 with the corresponding value in column A under Baseline for Example 1 in Table 1. However, the benefit of the contribution for this taxpayer is the same as the taxpayer faced prior to enactment of the Act. This is shown by comparing the Total Tax Benefit under column A under Final Rule with Notice 2019-12 with the corresponding value in column A under Prior Law for Example 1 in Table 1.

c. Comparison of contributions to different organizations and final rule with Notice 2019-12

Under the baseline and this rule with Notice 2019-12, for a taxpayer with state and local taxes paid over the SALT limitation, the value of a contribution to charity B, that is a contribution that results in a one-for-one state income tax deduction and not a state tax credit, is slightly higher than it was pre-Act. This increase is because the state deduction does not reduce the federal deduction for state and local taxes for a taxpayer above the SALT limitation. As shown in the Total Tax Benefit row under the B columns for Example 1, under the baseline and this rule with Notice 2019-12, the value of a \$1,000 contribution to charity B is \$290—the charitable contribution deduction from federal tax (\$1,000 multiplied by the 24 percent federal tax rate, or \$240), plus the value of the deduction from state tax (\$1,000 multiplied by the 5 percent state tax rate, or \$50)—compared to \$278 for contributions under prior law (described in Part IV.A3 previously). By comparison, as shown in the Total Tax Benefit row under the A columns

for Example 1, a contribution to charity A, eligible for a state tax credit, yields a \$1,240 tax benefit under the baseline and a \$1,000 benefit under this rule with Notice 2019-12.

2. Example 2: Taxpayer is below the SALT limitation and not subject to the AMT

a. Baseline

If a taxpayer who has state and local taxes paid below the SALT limitation and is not subject to the AMT makes the \$1,000 contribution to charity A, the deduction for charitable contributions under section 170(a) increases by \$1,000, and the deduction for state and local taxes paid under section 164 decreases by \$1,000. The taxpayer's itemized deductions, taxable income, and federal tax liability are unchanged from what they would be in the absence of the contribution. The taxpayer's state tax liability decreases by \$1,000 because of the state tax credit. The combined federal and state tax benefits of the \$1,000 contribution are therefore \$1,000, and the cost to the taxpayer and to the federal government of making the contribution is \$0. This situation is identical to prior law or what the taxpayer faced prior to enactment of the Act. This is shown in column A under Baseline and Prior Law for Example 2 in Table 1.

b. Final rule with Notice 2019-12

If the same taxpayer makes the \$1,000 contribution to charity A under the proposed rule, the entire \$1,000 contribution is not deductible under section 170(a), but the deduction for state and local taxes paid under section 164 still decreases by \$1,000 because of the \$1,000 state tax credit. If the taxpayer is in the 24 percent bracket, the federal tax liability will increase by \$240. The taxpayer's state tax liability decreases by the \$1,000 state tax credit. The combined federal and state tax benefits of the \$1,000 contribution are therefore \$760, or \$240 less than the baseline. This is shown by

comparing the Total Tax Benefit in column A under Proposed Rulemaking with the corresponding value in column A under Baseline for Example 2. In this case, the proposed rule has the effect of increasing the taxpayer's federal taxable income compared to the baseline if the taxpayer makes a contribution to charity A.

One commenter to the proposed regulations suggested that Example 2 be revised to indicate that the purported donation is a tax for purposes of section 164 if the state is the donee. As noted earlier in the preamble, that issue is outside of the scope of these regulations, but the Treasury Department and the IRS have issued Notice 2019-12, which provides a safe harbor for certain individuals. As described earlier in the preamble, under the safe harbor, an individual who itemizes deductions and who makes a payment to a section 170(c) entity in return for a state or local tax credit may treat the portion of such payment that is disallowed as a charitable contribution deduction under section 170 as a payment of state or local tax for purposes of section 164. This disallowed portion of the payment may be treated as a payment of state or local tax under section 164 when the individual applies the credit to offset the individual's state or local tax liability.

Under the final rule with Notice 2019-12, if the same taxpayer makes the \$1,000 contribution to charity A, the entire \$1,000 contribution is not deductible under section 170(a), but the deduction for state and local taxes paid under section 164 is unchanged because of the safe harbor. The taxpayer's federal liability is unchanged. The taxpayer's state tax liability decreases by the \$1,000 state tax credit. The combined federal and state tax benefits of the \$1,000 contribution are therefore \$1,000, the same as under prior law and the baseline. This is shown by comparing the Total Tax Benefit

in column A under Final Rule with Notice 2019-12 with the corresponding value in column A under Baseline for Example 2.

c. Comparison of contributions to different organizations, under prior law, baseline, and final rule with Notice 2019-12

Under the baseline scenario and this final rule with Notice 2019-12, the tax benefit of charitable contributions to charity B, which are not eligible for a state tax credit but are deductible from both federal and state taxable income, is unchanged from prior law for taxpayers below the SALT limitation. Thus, in this example, the benefit of making a contribution to charity B remains \$278, as described previously. This is shown in the Total Tax Benefit row under the B columns for Example 2. By comparison, as shown in the Total Tax Benefit row under the A columns for Example 2, a \$1,000 contribution to charity A, eligible for a state tax credit, yields a \$1,000 tax benefit under the baseline and under the final rule with Notice 2019-12. Under the final rule with Notice 2019-12 contributions to charity A are less costly than contributions to charity B in the same manner as under prior law for taxpayers with itemized state and local tax deductions of \$10,000 or less.

3. Example 3: Taxpayer is subject to the AMT<sup>6</sup>

a. Baseline

If a taxpayer subject to the AMT makes a \$1,000 contribution to charity A, the contribution reduces the taxpayer's taxable income under the AMT by \$1,000. Using an AMT marginal tax rate of 26 percent, the federal tax benefit of this \$1,000 contribution is

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<sup>6</sup> The Act increased the amount of income exempt from AMT. The Treasury Department estimates that in 2018 only about 150,000 taxpayers will be subject to the AMT under the Act, compared to more than 5 million under prior law.

\$260. Because of the dollar-for-dollar state tax credit, the taxpayer would receive a combined federal and state tax benefit of \$1,260 for a \$1,000 contribution, or a \$260 net benefit. This result is identical to the result under prior law (prior to enactment of the Act). This is shown in the A columns under Baseline and Prior Law for Example 3 in Table 1.

b. Final Rule with Notice 2019-12

If the same taxpayer makes the \$1,000 contribution to charity A under the final rule with Notice 2019-12, the entire \$1,000 is not deductible under section 170(a). Therefore, the taxpayer's taxable income and federal tax liability under the AMT would be unchanged from what they would be in the absence of the contribution. The taxpayer's state tax liability decreases by \$1,000 because of the state tax credit. The combined federal and state tax benefits of the \$1,000 contribution are therefore \$1,000, or \$260 less than under the baseline and under the law prior to enactment of the Act. This is shown by comparing the A columns of Example 3 in Table 1. However, under the rule, taxpayers subject to the AMT are in the same position as other taxpayers making a \$1,000 contribution to charity A. This is shown by comparing the Total Tax Benefit amount under column A for the Final Rule with Notice 2019-12 for Example 3 to that for Examples 1 and 2.

c. Comparison of contributions to different organizations, under prior law, baseline and final rule with Notice 2019-12

Under the baseline and the final rule with Notice 2019-12, the treatment of charitable contributions that are deductible from both federal and state taxable income is unchanged from prior law for taxpayers subject to the AMT. This is shown in the B

columns for Example 3 in Table 1. In this example, the benefit of making a contribution to charity B remains \$310, as described previously for contributions under prior law. By comparison, a contribution to a charity A, eligible for a state tax credit, yields a \$1,260 tax benefit under the baseline and a \$1,000 benefit under the final rule with Notice 2019-12. This is shown in column A under Baseline and Final Rule with Notice 2019-12 for Example 3 in Table 1.

#### 4. Example 4: State tax credit of 15 percent or less

Suppose, for this example only, that contributions to charity A generate a state tax credit with a rate of 10 percent, instead of 100 percent as described in Examples 1 through 3. If a taxpayer makes the \$1,000 contribution to charity A under the final rule with Notice 2019-12, the deduction for charitable contributions under section 170(a) increases by \$1,000. The deduction under section 170(a) is not reduced by the value of the credit because it does not exceed 15 percent. Thus, the taxpayer's federal tax liability is the same under the final regulations as under the baseline. The result is also the same as it would have been if the taxpayer's marginal state tax rate were 10 percent and the taxpayer were allowed a dollar-for-dollar deduction from state taxable income instead of a credit.

If the taxpayer is above the SALT limitation or subject to the AMT, the taxpayer's taxable income under the regular tax and under the AMT decreases by \$1,000. If the taxpayer is not subject to the AMT and is in the 24 percent bracket, federal tax liability will decrease by \$240, and state tax liability will decrease by \$100. The combined federal and state tax benefits of the \$1,000 contribution are therefore \$340. If the taxpayer is subject to the AMT and has an AMT marginal tax rate of 26 percent, federal

tax liability will decrease by \$260, and state tax liability will decrease by \$100, yielding a combined federal and state benefit of \$360 for the \$1,000 contribution.

If the taxpayer is below the SALT limitation, the taxpayer's deduction for state and local taxes treated as paid under section 164 decreases by \$100, and the taxpayer's taxable income decreases by \$900. If the taxpayer is in the 24 percent bracket, federal tax liability will decrease by \$216, and state tax liability will decrease by \$100. The combined federal and state tax benefits of the \$1,000 contribution are therefore \$316.

## V. Expected Benefits and Costs

### A. Benefits

This regulation likely reduces economically inefficient choices motivated by the potential tax benefits available if this regulation were not promulgated. Under the prior law and baseline scenarios, state and local governments have an incentive to fund governmental activities through entities that are eligible to receive deductible contributions and to establish tax credits. This incentive is particularly strong under a SALT limitation scenario where state and local governments may do so solely to enable some taxpayers to circumvent the SALT limitation. The final rule with Notice 2019-12 substantially diminishes this incentive to engage in economically inefficient tax-avoidance behavior. As a result, it is expected that fewer such credit programs would be established in the future under the rule than under the baseline.

To the extent this result occurs, the Treasury Department and the IRS estimate that this rule would reduce the overall complexity burden for states and for taxpayers who would otherwise make charitable contributions solely for the purpose of reducing

their state and local tax liability. In addition, the Treasury Department and the IRS anticipate that the rule will also spare some taxpayers compliance costs associated with complex tax planning designed to avoid the SALT limitation.

In addition, the rule is expected to make the federal tax system more neutral to taxpayers' decisions regarding making donations to state and local tax credit programs versus making donations to other, similar charitable organizations that do not give rise to state or local tax credits. Under the baseline scenarios, the combined federal and state tax benefits favor contributions to organizations that give rise to a state tax credit for taxpayers, particularly for taxpayers above the SALT limitation. Under the final rule and Notice 2019-12, this economic distortion is expected to be reduced.

The proposed regulations requested comments from the public on the potential extent of this expected reduction in economic distortion. One commenter responded that increased neutrality in the treatment of contributions to organizations that qualify for tax credits and those that do not is not a benefit of the rule. The commenter argued that such a conclusion ignores the possibility that tax credit programs provide a social benefit. The conclusion in the proposed regulations does not ignore the social benefits that tax credit programs might provide. The Treasury Department and the IRS have clarified in Part IV previously that their analysis was specific to cases where two organizations, one eligible for tax credits and the other not, are equally efficient in their provision of similar public goods. That is, both provide the same social benefit given the same level of contributions.

Finally, the final rule provides more certainty to taxpayers by clarifying the rules governing the amount that they can claim as a charitable contribution deduction when

they receive or expect to receive a state or local tax credit or a state or local tax deduction in exchange for the contribution.

One commenter asserted that increased certainty is not a benefit of this rule because other possible rules could also have provided certainty. While the commenter is correct that rules other than the proposed and final rule could also provide certainty, it remains the case that the proposed and final rule provide the benefit of certainty, relative to the baseline of no regulatory guidance at all.

One commenter suggested that the proposed rule would be beneficial because it would promote more efficient state and local spending decisions by making taxpayers bear more of the true cost of those decisions. The SALT limitation imposed by the Act reduced the federal subsidy of state and local spending, and the rule is consistent with this purpose of the Act provision. The reduction in the subsidy has the potential to make state spending decisions more efficient.

#### B. Costs

The rule may result in some increase in compliance costs for taxpayers who make contributions that generate state or local tax credits. Under the baseline, for purposes of the charitable contribution deduction under section 170(a), taxpayers did not need to address state or local tax credits received or expected to be received for purposes of claiming a charitable contribution; however, they would know the amount of credits received as part of the filing process for state returns. In contrast, under the final rule with Notice 2019-12, taxpayers making a contribution to an organization described in section 170(c) will need to determine the amount of any state or local tax credits they received or expect to receive in order to reduce their charitable contribution deduction

under section 170(a). This additional step will generate some additional compliance costs.

The compliance burden for recipient organizations that directly issue tax credits may increase under the rule. Under section 170(f)(8), in order to take a charitable contribution deduction of \$250 or more, a taxpayer must have a contemporaneous written acknowledgment (CWA) from the donee entity, usually provided in the form of a letter. The CWA includes the amount received by the entity or a description of property received. The CWA must also disclose whether the donee provided any goods or services in consideration for the contribution and a description and good faith estimate of the value of those goods or services. State and local tax credits are not generally provided by the donee entity, but there may be situations in which the entity would be providing the credit and would need to disclose the credit amount in the CWA provided to the donor. The proposed regulations requested comments on whether additional guidance is needed on substantiation and reporting requirements for donors and donees making or receiving payments or transfers of property in return for state and local tax credits and the extent to which entities do provide tax credits under certain circumstances. As mentioned earlier in this preamble, some commenters expressed concerns about substantiation of a charitable contribution when the donee does not know whether the donor receives or expects to receive a state or local tax credit. If a donee is not the entity providing the credit, the CWA rules do not require that the amount of the credit be reported in the acknowledgment. This mitigates the compliance burden for these entities.

The proposed regulations requested comments as to how the rule might alter incentives regarding contributions to state and local tax credit programs. As mentioned previously in the preamble, many commenters expressed concern that the rule would result in an overall decline in charitable giving and in declines in charitable giving to entities or causes they deem to be particularly meritorious. One commenter expressed concern about the lack of evidence provided in support of the statement that this rule will have at most a highly limited, marginal effect on taxpayer decisions to donate to tax credit programs, and the statement that most taxpayers have never contributed to such programs. Another commenter asserted that the rule would cause states to drop tax credit programs that support conservation easements. The commenter noted that this was particularly likely to occur in low-tax states, where more taxpayers will have SALT deductions under \$10,000. Several other commenters asserted that a substantial share of donors to tax credit organizations would be affected by the rule.

Based on an analysis of confidential taxpayer return data and forecasts using that data, the Treasury Department and the IRS estimate that this rule will leave charitable giving incentives entirely unchanged for the vast majority of taxpayers. The Treasury Department and the IRS estimate that, after passage of the Act (which significantly increased the standard deduction), 90 percent of taxpayers will not claim itemized deductions of any kind. Those taxpayers are entirely unaffected by this rule.

Approximately five percent of taxpayers are projected to claim itemized deductions and have state and local income tax deductions in excess of the SALT limitation. Under the rule and Notice 2019-12, taxpayers in this group who are not subject to the AMT will receive the same federal tax treatment for donating to

organizations providing tax credits as they received prior to the Act, as shown in Example 1 in Table 1 of this special analysis.

Approximately five percent of taxpayers are projected to claim itemized deductions and have SALT deductions below the limitation. Taxpayers in this group who are not subject to the AMT would have faced smaller incentives to donate to organizations resulting in state or local tax credits in excess of 15 percent under the proposed rule. However, these taxpayers will receive the same federal tax benefits for cash contributions under the final rule and Notice 2019-12 as they received prior to the Act and under the baseline, as described in Example 2 in Table 1 of this special analysis.<sup>7</sup>

It is the case that, for taxpayers subject to the AMT, the cost of giving to state and local credit organizations is higher under the rule with Notice 2019-12 than under the baseline and under prior law. The Treasury Department and the IRS estimate that fewer than 150,000 taxpayers (less than 0.1 percent of taxpayers) will be subject to the AMT and claim itemized deductions after enactment of the Act. These taxpayers could be affected by the final rule, but only if they contribute to programs that entitle them to state and local tax credits of greater than 15 percent. (The tax data do not indicate whether a taxpayer has made a contribution that generated a state or local tax credit.) However, as described in Example 3 in Table 1 of this special analysis, the cost of contributing to an organization resulting in a 100 percent state tax credit will be zero for these taxpayers, as it is for other taxpayers under the final rule with Notice 2019-12.

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<sup>7</sup> Taxpayers who contribute property do not satisfy the requirements of the safe harbor provided in Notice 2019-12 and may be impacted by the final regulations.



**Table 1: Tax Treatment of \$1,000 Contribution to (A) Organization that Gives Rise to \$1,000 State Tax Credit and (B) Organization for Which Contribution is Deductible at the State Level**

**Example 1: Taxpayer Above the SALT Limitation, Not Subject to the AMT; Taxpayer Remains Above SALT Limitation After Contribution**

| Change in                                    | Prior Law |       | Baseline |        | Proposed Rulemaking |        | Final Rule with Notice 2019-12 |        |
|--|-----------|-------|----------|--------|---------------------|--------|--------------------------------|--------|
|  | A         | B     | A        | B      | A                   | B      | A                              | B      |
| State Income Tax Liability                   | -1,000    | -50   | -1,000   | -50    | -1,000              | -50    | -1,000                         | -50    |
| Federal Income Tax                           |           |       |          |        |                     |        |                                |        |
| Charitable Contribution Deduction            | 1,000     | 1,000 | 1,000    | 1,000  | 0                   | 1,000  | 0                              | 1,000  |
| Deduction for State and Local Taxes          | -1,000    | -50   | 0        | 0      | 0                   | 0      | 0                              | 0      |
| Itemized Deductions                          | 0         | 950   | 1,000    | 1,000  | 0                   | 1,000  | 0                              | 1,000  |
| Taxable Income                               | 0         | -950  | -1,000   | -1,000 | 0                   | -1,000 | 0                              | -1,000 |
| Federal Tax Liability                        | 0         | -228  | -240     | -240   | 0                   | -240   | 0                              | -240   |
| Total Tax Benefit (Federal + State)          | 1,000     | 278   | 1,240    | 290    | 1,000               | 290    | 1,000                          | 290    |
| Net Cost to Taxpayer of \$1,000 Contribution | 0         | 722   | -240     | 710    | 0                   | 710    | 0                              | 710    |

**Example 2: Taxpayer Below the SALT Limitation, Not Subject to the AMT**

| Change in                           | Prior Law |       | Baseline |       | Proposed Rulemaking |       | Final Rule with Notice 2019-12 |       |
|-------------------------------------|-----------|-------|----------|-------|---------------------|-------|--------------------------------|-------|
|                                     | A         | B     | A        | B     | A                   | B     | A                              | B     |
| State Income Tax Liability          | -1,000    | -50   | -1,000   | -50   | -1,000              | -50   | -1,000                         | -50   |
| Federal Income Tax                  |           |       |          |       |                     |       |                                |       |
| Charitable Contribution Deduction   | 1,000     | 1,000 | 1,000    | 1,000 | 0                   | 1,000 | 0                              | 1,000 |
| Deduction for State and Local Taxes | -1,000    | -50   | -1,000   | -50   | -1,000              | -50   | 0                              | -50   |
| Itemized Deductions                 | 0         | 950   | 0        | 950   | -1,000              | 950   | 0                              | 950   |
| Taxable Income                      | 0         | -950  | 0        | -950  | 1,000               | -950  | 0                              | -950  |

|  |       |      |       |      |     |      |       |      |
|--|-------|------|-------|------|-----|------|-------|------|
| Federal Tax Liability                        | 0     | -228 | 0     | -228 | 240 | -228 | 0     | -228 |
| Total Tax Benefit (Federal + State)          | 1,000 | 278  | 1,000 | 278  | 760 | 278  | 1,000 | 278  |
| Net Cost to Taxpayer of \$1,000 Contribution | 0     | 722  | 0     | 722  | 240 | 722  | 0     | 722  |

**Example 3: Taxpayer Subject to the AMT**

| Change in                                    | Prior Law |        | Baseline |        | Proposed Rulemaking |        | Final Rule with Notice 2019-12 |        |
|--|-----------|--------|----------|--------|---------------------|--------|--------------------------------|--------|
|  | A         | B      | A        | B      | A                   | B      | A                              | B      |
| State Income Tax Liability                   | -1,000    | -50    | -1,000   | -50    | -1,000              | -50    | -1,000                         | -50    |
| Federal Income Tax                           |           |        |          |        |                     |        |                                |        |
| Alternative Minimum Taxable Income           | -1,000    | -1,000 | -1,000   | -1,000 | 0                   | -1,000 | 0                              | -1,000 |
| Federal Tax Liability                        | -260      | -260   | -260     | -260   | 0                   | -260   | 0                              | -260   |
| Total Tax Benefit (Federal + State)          | 1,260     | 310    | 1,260    | 310    | 1,000               | 310    | 1,000                          | 310    |
| Net Cost to Taxpayer of \$1,000 Contribution | -260      | 690    | -260     | 690    | 0                   | 690    | 0                              | 690    |

Assumptions: The taxpayer itemizes deductions and has more than \$1,000 of state tax liability. Under prior law, the taxpayer is not subject to the overall limitation on itemized deductions under section 68. The taxpayer faces a 24 percent marginal rate under the Federal income tax. If the taxpayer is subject to the AMT, the taxpayer faces a 26 percent marginal rate. A \$1,000 contribution to charitable organization A generates a \$1,000 state tax credit. A \$1,000 contribution to charitable organization B is ineligible for a state tax credit but is deductible under the state's income tax. The taxpayer faces a 5 percent marginal rate under the state's income tax. The baseline assumes continuation of the IRS administrative position that state and local tax credits are not reflected as a return benefit or consideration and therefore do not reduce the taxpayer's charitable contribution deduction under section 170(a). Total Tax Benefit refers to the absolute value of the reduction of the taxpayer's combined federal and state tax liability.

### Regulatory Flexibility Act

As noted previously, pursuant to the RFA (5 U.S.C. chapter 6), it is hereby certified that this rule will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the regulations primarily affect individuals. It is possible for a small business donor to be affected by this rule. However, small entities will often be able to claim a business expense deduction instead of a charitable donation, and would therefore be unaffected by the rule. For the very few small entity donors that might nevertheless choose to claim a charitable donation deduction and might be directly affected by the regulation, there is no significant economic impact. The rule would impose only nominal costs of subtracting the amount of the credit from the amount contributed, in order to determine the deduction allowed under section 170. There is no collection of information requirement on small entities. Therefore, a regulatory flexibility analysis is not required. Pursuant to section 7805(f), the proposed regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses, and no comments were received.

### Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of \$100 million in 1995 dollars, updated annually for inflation. In 2018, that

threshold is approximately \$150 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

#### Executive Order 13132: Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This final rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

#### Congressional Review Act

The Administrator of the Office of Information and Regulatory Affairs of the Office of Management and Budget has determined that this is a major rule for purposes of the Congressional Review Act (CRA) (5 U.S.C. 801 et seq.).

#### **Drafting Information**

The principal authors of these regulations are personnel from the Office of the Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and the Treasury Department participated in their development.

#### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

#### **Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.170A-1 is amended by redesignating paragraphs (h)(3) through (5) as paragraphs (h)(4) through (6), and adding a new paragraph (h)(3) to read as follows:

§1.170A-1 Charitable, etc., contributions and gifts; allowance of deduction.

\* \* \* \* \*

(h) \* \* \*

(3) Payments resulting in state or local tax benefits—(i) State or local tax credits.

Except as provided in paragraph (h)(3)(vi) of this section, if a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c), the amount of the taxpayer's charitable contribution deduction under section 170(a) is reduced by the amount of any state or local tax credit that the taxpayer receives or expects to receive in consideration for the taxpayer's payment or transfer.

(ii) State or local tax deductions—(A) In general. If a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c), and the taxpayer receives or expects to receive state or local tax deductions that do not exceed the amount of the taxpayer's payment or the fair market value of the property transferred by the taxpayer to the entity, the taxpayer is not required to reduce its charitable contribution deduction under section 170(a) on account of the state or local tax deductions.

(B) Excess state or local tax deductions. If the taxpayer receives or expects to receive a state or local tax deduction that exceeds the amount of the taxpayer's payment or the fair market value of the property transferred, the taxpayer's charitable contribution deduction under section 170(a) is reduced.

(iii) In consideration for. For purposes of paragraph (h)(3)(i) of this section, the term in consideration for shall have the meaning set forth in §1.170A-13(f)(6), except that the state or local tax credit need not be provided by the donee organization.

(iv) Amount of reduction. For purposes of paragraph (h)(3)(i) of this section, the amount of any state or local tax credit is the maximum credit allowable that corresponds to the amount of the taxpayer's payment or transfer to the entity described in section 170(c).

(v) State or local tax. For purposes of paragraph (h)(3) of this section, the term state or local tax means a tax imposed by a State, a possession of the United States, or by a political subdivision of any of the foregoing, or by the District of Columbia.

(vi) Exception. Paragraph (h)(3)(i) of this section shall not apply to any payment or transfer of property if the total amount of the state and local tax credits received or expected to be received by the taxpayer is 15 percent or less of the taxpayer's payment, or 15 percent or less of the fair market value of the property transferred by the taxpayer.

(vii) Examples. The following examples illustrate the provisions of this paragraph (h)(3). The examples in paragraph (h)(6) of this section are not illustrative for purposes of this paragraph (h)(3).

(A) Example 1. A, an individual, makes a payment of \$1,000 to X, an entity described in section 170(c). In exchange for the payment, A receives or expects to receive a state tax credit of 70 percent of the amount of A's payment to X. Under paragraph (h)(3)(i) of this section, A's charitable contribution deduction is reduced by

\$700 (0.70 x \$1,000). This reduction occurs regardless of whether A is able to claim the state tax credit in that year. Thus, A's charitable contribution deduction for the \$1,000 payment to X may not exceed \$300.

(B) Example 2. B, an individual, transfers a painting to Y, an entity described in section 170(c). At the time of the transfer, the painting has a fair market value of \$100,000. In exchange for the painting, B receives or expects to receive a state tax credit equal to 10 percent of the fair market value of the painting. Under paragraph (h)(3)(vi) of this section, B is not required to apply the general rule of paragraph (h)(3)(i) of this section because the amount of the tax credit received or expected to be received by B does not exceed 15 percent of the fair market value of the property transferred to Y. Accordingly, the amount of B's charitable contribution deduction for the transfer of the painting is not reduced under paragraph (h)(3)(i) of this section.

(C) Example 3. C, an individual, makes a payment of \$1,000 to Z, an entity described in section 170(c). In exchange for the payment, under state M law, C is entitled to receive a state tax deduction equal to the amount paid by C to Z. Under paragraph (h)(3)(ii)(A) of this section, C's charitable contribution deduction under section 170(a) is not required to be reduced on account of C's state tax deduction for C's payment to Z.

(viii) Effective/applicability date. This paragraph (h)(3) applies to amounts paid or property transferred by a taxpayer after August 27, 2018.

\* \* \* \* \*

#### §1.170A-13 [Amended]

Par. 3. Section 1.170A-13 is amended in paragraph (f)(7) by removing the cross-reference “§1.170A-1(h)(4)” and adding in its place “§1.170A-1(h)(5)”.

Par. 4. Section 1.642(c)-3 is amended by adding paragraph (g) to read as follows:

§1.642(c)-3 Adjustments and other special rules for determining unlimited charitable contributions deduction.

\* \* \* \* \*

(g) Payments resulting in state or local tax benefits—(1) In general. If the trust or decedent's estate makes a payment of gross income for a purpose specified in section

170(c), and the trust or decedent's estate receives or expects to receive a state or local tax benefit in consideration for such payment, §1.170A-1(h)(3) applies in determining the charitable contribution deduction under section 642(c).

(2) Effective/applicability date. Paragraph (g)(1) of this section applies to payments of gross income after August 27, 2018.

Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

Approved: June 3, 2019

David J. Kautter,

Assistant Secretary of the Treasury (Tax Policy).

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