

# IRS Rule on Charitable Deductions: A Worthy Goal, a Skillful Fix, but Surprisingly Thin Evidence

By: Jerry Ellig | June 17, 2019

Earlier this week, the Internal Revenue Service (IRS) released a [final regulation](#) that prohibits individual taxpayers from taking a tax deduction for a charitable contribution if the individual received a state or local tax credit in exchange for the contribution. The regulation seeks to accomplish a worthy goal, and a [supplementary notice](#) fixes a significant shortcoming in the [proposed regulation](#). In the accompanying economic analysis, however, the evidence of a problem justifying the regulation is surprisingly thin.

## A worthy goal

The regulation was proposed in August 2018 in response to newly-adopted state schemes that sought to help taxpayers evade the \$10,000 cap on federal deductions for state and local taxes (commonly known as the ‘SALT cap’). In the absence of this regulation, states face incentives to fund programs by granting tax credits in exchange for donations, and some have done so. This effectively disguises state revenues as charitable donations rather than income taxes. Taxpayers whose tax liabilities exceed the SALT cap can make donations to the new programs, receive tax credits that reduce their state tax liabilities, and receive a federal charitable deduction for a donation that they could not deduct if it were a tax payment – thus partially or fully circumventing the SALT cap. The IRS regulation plugs this loophole.

## A skillful fix

As proposed, the regulation was broader than necessary to deal with the stated problem – evasion of the SALT cap. This is because the regulation also prohibited individuals with state and local taxes *below* the SALT cap from receiving a federal tax deduction for a covered charitable contribution. The final regulation retains this prohibition.

But along with the regulation, the IRS published a [notice](#) stating that individuals with state and local income taxes below the SALT cap can count as state and local taxes the contributions for which they receive state or local tax credits. Thus, individuals below the SALT cap can still deduct some or all of these contributions – but only by categorizing them as state or local taxes, whose deductibility is subject to the cap.

## In brief...

The IRS’s new rule prohibiting individual taxpayers from deducting charitable contributions on their federal taxes if they received a state or local tax (SALT) credit is a logical solution to a problem created by the overly-broad proposed regulation.

The rationale for allowing individuals to classify these donations as tax payments is that the state tax credit programs effectively give the taxpayer a choice of making a tax payment or donating to an entity for which the state offers a tax credit. Either way, the taxpayer has to make a payment. The tax credit just lets the taxpayer exercise some control over how the payment will be used. So there is little justification for treating different kinds of payments differently.

Without the safe harbor provided by the notice, an individual below the SALT cap could deduct the tax payment but could not deduct an equivalent donation for which he or she receives a tax credit. The [preamble](#) to the final regulation provides the example of an individual in the 24 percent tax bracket who is below the SALT cap. If the taxpayer makes a \$1000 donation and receives a \$1000 state tax credit, the taxpayer's federal taxes increase by \$240 because the donation is not deductible due to the new regulation. The safe harbor eliminates this \$240 penalty by allowing the taxpayer to count the donation as a state tax payment.

I noted this problem in a [comment](#) on the regulation I submitted to the IRS, but I was not clever enough to come up with the logical solution the IRS proposed in the notice. (The IRS stated that it intends to propose a regulation implementing the notice. Currently the notice is in the [docket](#), but there is not yet a proposed rule. Public comments on the notice will be accepted through July 11, 2019.)

### **Surprisingly thin evidence**

The IRS's economic analysis does very little to demonstrate the potential size of the problem the regulation is intended to solve. This sets a dangerous precedent for future regulations.

The [preamble](#) to the final regulation asserts that allowing deductions for donations when taxpayers receive state or local tax credits "would precipitate revenue losses that would undermine the limitation on the deduction for state and local taxes adopted by Congress under the Act." It cites a Joint Committee on Taxation estimate that the SALT cap plus other limitations on itemized deductions in the Tax Cuts and Jobs Act (TCJA) would raise \$668 billion over ten years, suggesting that this is an upper bound of the possible revenue loss if the regulation is not adopted.

The argument is plausible, but not very well-supported with evidence. The IRS could have made a stronger case that the problem is large by reporting the amount of revenue that could be affected by tax credit plans actually [proposed or adopted](#) in large, high-tax states in response to the TCJA. That kind of information is the difference between policymaking based on evidence and policymaking based on assertions.

I am less concerned that the IRS made the wrong decision on this regulation than I am concerned about the precedent that this kind of argument by assertion sets for development of regulations in future situations where the facts may be less clear.

(For more detailed discussion of the IRS's responsibilities for assessing the economic effects of its regulations, see Bridget Dooling's working paper, "[Expanding OIRA Review to IRS](#)," and my article in *Tax Notes*, "[Economic Analysis of Tax Regulations: A First-Year Assessment](#).")