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IRS Tax Credit Regulation: Too Much SALT?

[Jerry Ellig](#) | October 15, 2018

The comment period just closed on an Internal Revenue Service (IRS) [regulation](#) that would prohibit taxpayers from claiming a charitable deduction if the taxpayer receives a state or local tax credit exceeding 15% of the value of the donation. The regulation is intended to counteract large [tax credit programs](#) that high-tax states enacted or are considering in response to the Tax Cuts and Jobs Act of 2017, which limited the federal tax deduction for state and local taxes to \$5,000 for individuals and \$10,000 for couples (the “SALT cap”).

This regulation is one of the first [significant](#) IRS regulations proposed after the Treasury Department and Office of Management and Budget signed a [Memorandum of Agreement](#) stating that significant tax regulations would be subject to the economic analysis requirements and review procedures outlined in [Executive Order 12866](#). The executive order requires agencies to identify and assess the significance of the problem the regulation is intended to solve, tailor the regulation to solve the problem while imposing the least burden on society, and assess the benefits and costs of the regulation.

As proposed, the tax credit regulation is overly broad, precisely because the regulation and accompanying analysis fail to comply with these key principles in the executive order. A more carefully tailored regulation would (1) grandfather the tax credit programs that existed before the 2017 tax reform passed, since these programs were not enacted to evade the SALT cap; (2) establish standards for determining whether new tax credit programs are for legitimate charitable purposes or are simply SALT cap avoidance schemes, and permit deductibility of the former; and (3) continue to allow taxpayers with state and local taxes below the SALT cap to deduct contributions to legitimate charities for which they receive tax credits.

Problem Analysis

The Notice of Proposed Rulemaking (NPRM) identifies a potentially significant problem: newly-minted state tax credit programs created for the express purpose of helping taxpayers evade the state and local tax deduction (SALT) cap. A taxpayer above the cap could “donate” money to state or local governments, receive a state tax credit for most or all of the donation, then claim the donation as a tax deduction. Voila, a non-deductible state or local tax payment would be turned into a deductible “charitable” donation, effectively allowing the taxpayer to avoid the SALT cap.

Unfortunately, the NPRM includes no evidence showing how significant this problem may be—despite widespread [media coverage](#) of the state tax credit workarounds. If the IRS provided estimates of the potential federal revenue losses, based on the tax credit programs some states recently adopted or considered, it could well find that this is a problem worth solving.

Alternatives

The regulation is not adequately targeted to address the problem at hand: new state tax credit programs that let taxpayers above the SALT cap avoid the cap. Charitable deductions would be prohibited if the taxpayer received a state or local tax credit exceeding 15 percent of the value of the donation (a de minimis amount that is less than or equal to the value of a tax deduction).

That means the tax deduction would be denied for legitimate charitable contributions that currently receive state tax credits, such as [conservation easements and scholarship programs](#) for K-12 private schools. In addition, taxpayers whose state and local taxes are below the SALT cap would also be denied the ability to deduct charitable contributions for which they received tax credits. The IRS's own numerical examples in the NPRM show that the regulation would in effect impose a federal tax on these taxpayers' state and local tax credits, making them worse off than under current regulations.

Benefits and costs

Finally, the IRS should more rigorously assess the benefits and costs of the proposed rule. The NPRM rightfully recognizes the social waste associated with tax credit programs that are merely workarounds that allow taxpayers to avoid the SALT cap. It should also recognize the social waste that occurs because these tax avoidance programs reduce the cost of state and local spending for taxpayers who are above the SALT cap, thus likely allowing state or local spending to expand beyond the efficient level.

Two claimed “benefits” of the regulation—increased certainty for taxpayers, and greater neutrality between different kinds of charitable donations—are not supported by the economic analysis and should be dropped. As the [D.C. Circuit Court of Appeals](#) has recognized, “increased certainty” is not a benefit attributable to a regulation, because that is tantamount to saying that the issuance of any regulation automatically creates a benefit by reducing uncertainty. And the IRS cannot know whether reducing taxpayers' incentives to make donations for which they receive tax credits improves economic efficiency unless it evaluates the effectiveness of each tax credit in achieving the claimed public benefits—a type of analysis that is completely absent from the NPRM.

The cost assessment also needs work. The NPRM merely asserts, without evidence, that the cost of this rule to taxpayers below the SALT cap is likely to be minimal because Treasury and the IRS “believe” that few of these taxpayers use these tax credits and that taking away the federal income tax deduction will not affect their decisions very much. But regulatory decisions should be [grounded in real evidence](#), not just beliefs or intentions.

Conclusion

This regulation targets a problem that is potentially significant—new state tax credit programs that are merely SALT cap workarounds. A more careful assessment, however, reveals that the evidence of the problem presented in the NPRM is weak, the regulation is not tailored to address the problem at least social cost, some of the claimed benefits are not really benefits, and some

cost assessments are based on belief rather than evidence. Executive Order 12866 sets a higher standard for regulatory analysis.

READ THE AUTHOR'S PUBLIC INTEREST COMMENT [on](#)
IRS's Proposed Rule on SALT Credits

QUESTIONS?

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