THE GEORGE WASHINGTON UNIVERSITY

WASHINGTON, DC

Public Interest Comment[1] on

The Internal Revenue Service Proposed Rule

Contributions in Exchange for State or Local Tax Credits

Docket ID No. REG-112176-18
RIN: 1545-BO89

October 11, 2018

Jerry Ellig, Research Professor[2]

The George Washington University Regulatory Studies Center

The George Washington University Regulatory Studies Center improves regulatory policy through research, education, and outreach. As part of its mission, the Center conducts careful and independent analyses to assess rulemaking proposals from the perspective of the public interest. This comment on the Internal Revenue Service's (IRS) proposed rule, Contributions in Exchange for State or Local Tax Credits, does not represent the views of any particular affected party or special interest, but is designed to evaluate the effect of the IRS's proposal on overall consumer welfare.

Introduction

Many states offer full or partial state tax credits for charitable contributions to or investments in specific types of activities. Common examples include conservation easements and outright donations of land for environmental purposes, scholarship funds that enable students to attend private K-12 schools, donations to public school systems or universities, contributions for neighborhood improvement or economic development, and donation of food to food banks.[3]

[1] This comment reflects the views of the author, and does not represent an official position of the GW Regulatory Studies Center or the George Washington University. The Center's policy on research integrity is available at http://regulatorystudies.columbian.gwu.edu/policy-research-integrity.

[2] The author is a research professor at The George Washington University Regulatory Studies Center.

[3] For an extensive list, see Joseph Bankman, David Gamage, Jacob Goldin, Daniel Hemel, Darien Shanske, Kirk J. Stark, Dennis J. Ventry Jr., and Manoj Viswanathan, "State Responses to Federal Tax Reform: Charitable Tax Credits," *State Tax Notes* (April 30, 2018), Appendix.

Historically, most taxpayers have also received a full federal itemized charitable deduction for such contributions, because the state tax credit reduces the taxpayer's federal deduction for state and local taxes rather than the deduction for charity.[4] In the absence of such a deduction, the federal government would essentially be taxing the taxpayer's state tax credit.

The Tax Cuts and Jobs Act of 2017 limited an individual's itemized deductions for state and local taxes (SALT) to $10,000 annually ($5,000 for a married individual filing a separate return). In response, several states began developing new tax credit programs to fund state and local functions that would heretofore have been funded through taxation.[5] When a state shifts the funding of some state programs from tax revenues to tax credits, 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 the donation – thus partially or fully circumventing the SALT cap.

The proposed regulation seeks to prevent such behavior by requiring individuals to subtract the value of state or local tax credits from the associated donation in order to calculate the portion of the donation they are permitted to deduct as a charitable contribution. It allows taxpayers to disregard tax credits if they do not exceed 15 percent of the value of the donation, because a tax credit of this size is no greater than a state tax deduction for the donation.[6] This comment assesses the regulation and accompanying economic analysis with special emphasis on three key aspects of regulatory analysis outlined in Executive Order 12,866:

- **Problem analysis:** The NPRM identifies a potentially significant problem – state tax credits that circumvent the SALT cap – but provides little evidence demonstrating the size and significance of the problem. Estimates of the potential size of tax credits, federal revenue losses, and efficiency losses due to state SALT workaround schemes would make it easier to determine whether a regulation is necessary.

- **Alternatives:** The regulation is written more broadly than necessary to address the problem the NPRM identifies. Alternative forms of the regulation could tailor the rule to address the fundamental problem while imposing a lower burden on society. A revised final rule should focus on the source of the problem the IRS identifies: state tax credits enacted deliberately to aid taxpayers in avoiding the SALT cap. The charitable deduction should be retained for taxpayers below the SALT cap and for legitimate charitable contributions, even if the taxpayer receives a state tax credit.

4 NPRM, p. 43,564.

5 Laura Davison, "IRS Moves to Block New York Plan to Shirt SALT Deduction Cap," August 23, 2018, https://www.bloomberg.com/news/articles/2018-08-23/irs-blocks-new-york-new-jersey-plans-to-bypass-state-tax-cap.

6 NPRM, p. 43,565.

- **Benefits and costs:** Several alterations to the assessment of benefits and costs would provide a more accurate picture of the regulation's likely effects and could prompt different decisions on some aspects of the regulation. The regulation would not only prevent wasteful tax avoidance (which the NPRM discusses), but it would also promote more efficient state and local spending decisions by making each state's taxpayers bear more of the true cost of those decisions (a benefit the NPRM does not discuss). On the other hand, two claimed benefits of the regulation – increased neutrality between different kinds of charitable donations and increased certainty – are not supported by economic analysis and should be dropped. Finally, instead of simply assuming that the cost of this regulation to taxpayers below the SALT cap is negligible, the IRS should gather empirical evidence and if necessary conduct its own empirical studies to better understand how these taxpayers would change their behavior if they could no longer deduct charitable contributions for which they receive state tax credits.

Relevant Regulatory Analysis Requirements

The proposed regulation is one of the first regulations reviewed by the Office of Information and Regulatory Affairs (OIRA) under the April 11, 2018, Memorandum of Agreement (MOA) between the Treasury Department and the Office of Management and Budget (OMB).[7] As such, the regulation, supporting economic analysis, and the way the analysis affects decisions could set a major precedent for future significant tax regulations. At the same time, the potential need to complete this rule in time of year-end tax planning illustrates the urgency that often applies to IRS rulemakings.

OMB determined that this proposed regulation is subject to OMB review under Executive Orders 12,866 and 13,563 because it raises novel legal or policy issues.[8] Because OMB did not determine that the regulation has an annual non-revenue effect on the economy greater than or equal to $100 million annually, the IRS was not required to produce a quantified benefit-cost analysis of the proposed regulation and alternatives. However, the MOA between the Treasury Department and OMB notes that all provisions of Executive Order 12,866 not explicitly modified by the MOA apply to tax regulatory actions reviewed by OMB.[9] Such provisions include:

7 Brent McIntosh and Neomi Rao, Memorandum of Agreement, The Department of the Treasury and the Office of Management and Budget, Review of Tax Regulations Under Executive Order 12866 (April 11, 2018).

8 NPRM, p. 43,566.

9 Treasury-OMB Memorandum of Agreement, p. 2.

Problem Analysis. "Each agency shall identify the problem it intends to address (including, where applicable, the failures of private markets or public institutions that warrant new agency action) as well as assess the significance of that problem."[10]

Alternatives. An agency "shall design its regulations in the most cost-effective manner to achieve the regulatory objective"[11] and "tailor its regulations to impose the least burden on society…"[12] These provisions imply that the agency should consider alternative ways of writing the regulation.

Benefits and costs. "Each agency shall assess both the costs and benefits of the intended regulation…"[13]

All of the agency's analysis is subject to a cross-cutting requirement that "Each agency shall base its decisions on the best reasonably available scientific, technical, economic, and other information concerning the need for, and consequences of, the regulation."[14] The remainder of this comment is organized around the three elements of Regulatory Impact Analysis listed above, keeping in mind the requirement that agencies must rely on the best available evidence.

Problem Analysis

The NPRM clearly identifies the problem the IRS seeks to solve with this regulation. The regulation seeks to prevent taxpayers with state and local taxes exceeding the $10,000 SALT cap from circumventing the cap. If a taxpayer's state and local tax liabilities exceed the SALT cap, "state and local tax credit programs now give taxpayers a potential means to circumvent the $10,000 limitation … by substituting an increased charitable contribution deduction for a disallowed state and local tax deduction."[15] The NPRM also asserts that some states have adopted or are considering new state and local tax credit programs for the explicit purpose of circumventing the $10,000 limitation.[16] Such circumvention of the SALT cap undermines a key goal of the Tax Cuts and Jobs Act, which was to improve efficiency by making the tax code more neutral.

Although the theory of the underlying problem is clear, the NPRM provides surprisingly little evidence that the problem is significant. The primary evidence appears in footnote 1, which

10 Executive Order 12,866, §1(b)(1).

11 Executive Order 12,866, §1(b)(5).

12 Executive Order 12,866, §1(b)(11).

13 Executive Order 12,866, §1(b)(6). See also §6(a)(3)(B)(ii) (requiring the agency to provide OMB with an assessment of the potential benefits and costs of the regulatory action).

14 Executive Order 12,866, §1(b)(7).

15 NPRM, p. 43,564.

16 NPRM, p. 43,564.

contains the Joint Committee on Taxation's estimate of the revenue impact of multiple itemized deduction reforms and asserts that "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."[17]

In contrast, some language in the NPRM could be taken to imply that the potential problem is minimal. The NPRM states that most taxpayers will be unaffected by the regulation because the Treasury Department and IRS estimate that 90 percent of taxpayers will not itemize deductions due to the larger standard deduction.[18] Treasury and IRS further estimate that only 5 percent of taxpayers will itemize deductions and have state and local taxes exceed the SALT cap.[19] The NPRM contains no estimates of the amount of tax credits, federal revenue losses, or efficiency losses that would occur if this 5 percent of taxpayers takes advantage of new state and local tax credit programs that states are likely to create for the purpose of evading the SALT cap. Without this information, the IRS cannot know whether the potential problem is significant enough to justify this change in tax regulations.

Precise estimates may be difficult to generate, but some calculations that at least indicate a range of possibilities should be possible. Confidential return data could be used to estimate the total amount of state and local tax deductions that would exceed the SALT cap; this would be the upper-bound estimate of new charitable deductions the states could create with new tax credit programs crafted to circumvent the SALT cap. A more likely estimate could be produced by calculating the amount of new charitable deductions that would be created by tax credit programs that states have adopted or proposed since passage of the Tax Cuts and Jobs Act.[20]

If these new tax credit programs offer a credit of 100 percent or close to that amount, it would be reasonable to presume that taxpayers with state and local taxes above the SALT cap would take full advantage of them. Example 1 and Example 3 in Table 1 of the NPRM clearly indicate that under current regulations, taxpayers with state and local taxes exceeding the SALT cap, as well as taxpayers subject to the alternative minimum tax, have strong financial incentives to make contributions that receive a 100 percent state and local tax credit and also generate federal charitable deductions.[21] For these taxpayers, the net cost of their contributions receiving a 100 percent tax credit is actually negative! The taxpayer would profit, the state could collect more revenue than otherwise, and the US Treasury would lose tax revenue. To the extent that new or proposed tax credits are substantially less than 100 percent, the IRS would need to estimate the likely taxpayer response based on the change in net cost to the taxpayer.

---

17 NPRM, p. 43,565.

18 NPRM, p. 43,569.

19 NPRM, p. 43,569.

20 For examples of these new tax credit programs, see https://taxfoundation.org/state-strategies-preserve-state-and-local-tax-deduction/.

21 NPRM, pp. 43,569-70.

Armed with a range of estimates of the total amount of new tax credits, the IRS could then estimate revenue effects to the federal government and economic efficiency losses. One part of the economic efficiency loss would be the deadweight loss associated with raising this amount of revenue under the current federal tax code. Another part of the economic efficiency loss would be any reduction in efficiency that occurs because circumvention of the SALT cap artificially lowers the cost of state or local services to state and local taxpayers.

With estimates of the likely amount of tax credits, revenue loss, and efficiency loss, the IRS could then determine whether the problem is significant enough to warrant a change in longstanding practice.

Alternatives

The NPRM's clear statement of the problem the regulation is intended to solve makes it obvious that the regulation is broader than necessary to address the problem. The regulation is not tailored to impose the least burden on society, as Executive Order 12,866 requires, for two reasons. First, it curtails deductions for taxpayers below the SALT cap as well as for those above the SALT cap. Second, it applies to tax credits for donations to legitimate charitable causes as well as tax credit programs created largely for the purpose of evading the SALT cap. The IRS should consider alternative forms of the regulation that would tailor it more carefully to address the fundamental problem: new tax credit programs created for the purpose of avoiding the SALT cap.

Taxpayers below the SALT cap

The new regulation would apply to a class of taxpayers who are not a source of the problem the regulation seeks to solve.

Example 2 in Table 1 of the NPRM shows how pre-2017 law, post-2017 law without the proposed regulatory change, and post-2017 law with the proposed regulatory change would affect the net cost of a charitable contribution by a taxpayer below the SALT cap who receives a 100 percent tax credit.[22] Under pre-2017 law or post-2017 law without the proposed regulatory change, the net cost of the $1000 charitable contribution is zero. The taxpayer receives a tax credit, plus a federal income tax deduction for a charitable donation that offsets the federal deduction the taxpayer loses due to the lower state tax liability. Under the proposed regulatory change, however, that same $1000 charitable contribution costs the taxpayer $240 – obviously a substantial increase from zero.

[22] NPRM, pp. 43,569-70.

The NPRM attempts to downplay the effects of this regulatory overreach by asserting that "The Treasury Department and the IRS believe that most taxpayers in this third category have never used any state tax credit programs affected by the proposed regulations, and that the proposed regulations will have at most a highly limited, marginal effect on taxpayer decisions to donate to tax credit programs that pre-date TCJA, including educational scholarship programs."[23] Perhaps because this is a stated belief accompanied by no evidence, the NPRM appropriately calls for comment on this issue.[24]

It is understandable why the IRS cannot directly calculate the number of affected taxpayers in this group or the amount of revenue involved based solely on confidential federal taxpayer return data. Federal tax returns report itemized deductions, but charitable contributions that qualify for state tax credits are not reported separately on federal tax returns. I can think of two other possible ways to estimate the number of taxpayers and amount of revenue involved. First, employ state tax return data or persuade several states to undertake this analysis on their own. State tax returns should include a figure for state tax credits and for state and local tax deductions. Second, employ state-level data to econometrically estimate the correlation between the number or percentage of taxpayers under the SALT cap who itemize deductions and the number or percentage of individuals receiving tax credits in at least some state tax credit programs. A statistically significant positive correlation would suggest that deductibility of the contributions at issue is associated with the taxpayer's decision to contribute.[25]

Even if the number of affected taxpayers below the SALT cap is relatively small, the IRS is not justified in taking away their ability to deduct charitable donations for which they receive tax credits. These taxpayers are simply not a source of the tax avoidance behavior the regulation seeks to prevent.

Legitimate charitable causes

The new regulation would apply to tax credit programs that affect donations to legitimate charitable causes, not just tax credits created to avoid the SALT cap.

---

[23] NPRM, p. 43,569.

[24] NPRM, p. 43,569.

[25] State school choice programs that offer tax credits for tuition or donations to scholarship-granting organizations may be especially relevant candidates for such analysis. These programs usually provide tax credits equal to 65 percent or more of the donation; a 100 percent tax credit is not unusual. State and local tax credit programs for purposes other than educational choice often limit the tax credit to 50 percent or less of the donation. See Bankman et. al., "State Responses to Federal Tax Reform," Appendix. Data on each of the educational choice programs, including the number of participants and tax credit percentage, is available at https://www.edchoice.org/school-choice/school-choice-in-america/.

Tax credit programs created before the SALT cap was adopted are one example. It is unlikely that state and local tax credit programs enacted prior to 2018 were adopted with the primary purpose of avoiding the SALT cap, since the SALT cap did not exist until passage of the Tax Cuts and Jobs Act of 2017. Nevertheless, the proposed regulation applies to all state and local tax credits that exceed the de minimis threshold. To tailor the regulation more carefully to address the actual problem the IRS seeks to solve, the rule could grandfather the deductibility of charitable donations that stem from state and local tax credit programs adopted before 2018.

Tax credit programs created after 2017 might support legitimate charitable causes or they might be intended primarily to avoid the SALT cap. The regulation should target the latter type of tax credit. To do so, the IRS would need to articulate criteria for distinguishing tax credit programs that support legitimate charitable causes from those that are primarily motivated by SALT cap avoidance. Some possible criteria for a legitimate charitable donation exemption could include:

> **Private charity:** If the recipient of the donation is a private charity rather than the state government, then the state loses revenue as a result of the tax credit. Such donations are clearly not simply a substitution of one type of payment to the state for another.[26]
>
> **Functional equivalence:** If the recipient of the donation is a state or local entity that is operated in a manner functionally equivalent to a private charity – such as a state fund that provides school choice scholarships – then there is also a strong argument for allowing the donor to take a charitable deduction for the donation.
>
> **Legislative history:** The intentions behind tax credit SALT cap avoidance schemes are clear and obvious. The IRS should be able to examine the legislative history of new tax credit programs to determine whether the primary purpose is simply to replace one form of payment to the state or locality with another.

This list is not intended to be exhaustive. The broader point is that the IRS should tailor the regulation to address SALT cap avoidance schemes by grandfathering tax credits that existed before 2018 and allowing deductions for legitimate charitable donations.

Benefits and costs

The NPRM's economic analysis section includes a qualitative discussion of benefits and costs.

The first benefit listed is a reduction in "socially wasteful tax-avoidance behavior."[27] By eliminating the opportunity for states to establish tax credit programs solely for tax avoidance

---

[26] Jared Walczak, "The Ways of Paradox: What Renders a Contribution Deductible?," *Columbia Journal of Tax Law – Tax Matters* (2018), pp. 6-7.

[27] NPRM, p. 43,568.

purposes, the regulation would save the resources that states and taxpayers devote to this behavior. Resources wasted by individuals or organizations seeking to capture wealth transfers ("rent-seeking"[28] in economics jargon) are a significant source of economic inefficiency that is usually ignored in federal agencies' regulatory impact analyses. The IRS deserves credit for recognizing this type of benefit. The additional numerical analysis suggested above under "Problem Analysis" could assist the IRS in quantifying this benefit by identifying the size of the wealth transfer at stake – i.e., the difference in federal tax liabilities for taxpayers above the SALT cap in the baseline and proposed rule scenarios.

The regulation would also reduce the allocative inefficiency that could occur as a result of the tax avoidance schemes. Deductibility of state and local taxes effectively subsidizes state and local spending. Some studies find that this subsidy increases state and local spending by as much as 20 percent; others find more modest or no impact.[29] To fully assess the benefits and costs of this regulation, the IRS should assess whether tax credit programs designed to avoid the SALT cap would allow state and local spending to be higher than it would otherwise be, and whether that incremental spending generates any positive spillover effects that benefit federal taxpayers in low-tax states who are subsidizing this spending.

The NPRM also argues that the proposed regulation will make the tax system more neutral in regard to the taxpayer's choice between donations that qualify for a state tax credit and those that qualify only for a tax deduction.[30] By characterizing this effect as a "reduction in economic distortion,"[31] the NPRM presumes that any tax credit that produces a larger tax benefit than a tax deduction for the same donation must necessarily be a "distortion" that reduces economic efficiency. Making the tax benefit for each type of donation more uniform is presumed to reduce distortions.

This presumption is false. Legitimate tax credit programs are intended to produce public benefits. One cannot judge whether the amount or percentage of the tax credit is efficient or inefficient without knowing the size of the public benefits created by the tax credit.

Tax credits for educational choice provide an informative example. The tax credits are motivated by a belief that organization of public schooling as a monopoly has created substantial distortions and sub-optimal educational results. In other words, the tax credits attempt to remedy a "failure of public institutions"[32] analogous to a market failure. These tax credit programs seek to achieve

---

28 See, e.g., James M. Buchanan, Robert D. Tollison, and Gordon Tullock, *Toward a Theory of the Rent-Seeking Society* (College Station, TX: Texas A&M University Press, 1980).

29 Jared Walczak, "The State and Local Tax Deduction: A Primer," Tax Foundation *Fiscal Fact* No. 545 (March 15, 2017), https://taxfoundation.org/state-and-local-tax-deduction-primer/.

30 NPRM, pp. 43,568-69.

31 NPRM, p. 43,569.

32 Executive Order 12,866, §1(b)(1).

three public goals: (1) increase educational quality for families that move their children from public to private schools, (2) increase educational quality in the public schools by subjecting them to competition, and (3) reduce overall public sector educational costs by providing tax credits that are smaller than the typical cost of educating students in the public schools. A substantial body of research assesses how well these tax credit and other school choice programs achieve those goals.[33] The IRS cannot know whether a 100 percent tax credit for educational choice creates a "distortion" without evaluating the benefits the tax credit achieves.

Conducting empirical analysis of the benefits of most major state and local tax credit programs to reach a more definitive conclusion would require substantial resources. In addition, the claimed reduction in distortion is a separate issue from the fundamental problem that motivated the regulation. Therefore, I suggest that the IRS simply remove the discussion of this claimed benefit.

The NPRM also appears to claim that certainty and clarity for taxpayers are additional benefits of the regulation. This is inaccurate. "Certainty" is not a benefit attributable to the proposed regulation, because a regulation declaring that all charitable contributions at issue count as itemized deductions for all taxpayers could have reduced uncertainty just as well. As the D.C. Circuit stated in *American Equity v. Securities and Exchange Commission (SEC)*:

> The SEC cannot justify the adoption of a particular rule based solely on the assertion that the existence of a rule provides greater clarity to an area that remained unclear in the absence of any rule. Whatever rule the SEC chose to adopt could equally be said to make the previously unregulated market clearer than it would be without that adoption.[34]

Removing the claim that greater certainty counts as a benefit of the regulation would make the economic analysis more accurate.

Finally, the analysis of costs imposed on taxpayers below the SALT cap should be based on more than an unsupported "belief" that few of these taxpayers use state tax credits and that the federal income tax deductibility of such donations has little effect on their decisions.[35] The examples in Table 1 clearly demonstrate that the proposed rule would increase the cost of a $1000 donation that receives a 100 percent state tax credit from zero under current law to $240 under the proposed regulation.[36] Put another way, for taxpayers under the SALT cap, the proposed regulation imposes a 24 percent tax on a charitable contribution that receives a full

[33] An extensive bibliography of empirical studies evaluating the effects of school choice programs is available at https://www.edchoice.org/school-choice/empirical-research-literature-on-the-effects-of-school-choice/.

[34] *American Equity v. SEC*, 527 F3d 923, 936 (2009).

[35] NPRM, p. 43,569.

[36] NPRM, pp. 43,569-70.

state tax credit. It seems implausible that such a large increase in the cost of a donation would have a negligible effect on the incentive to donate. The IRS should examine empirical evidence or conduct its own empirical studies to ascertain the size of the effect. Such information may be a critical input into the decision to leave the regulation unchanged or allow taxpayers below the SALT cap to deduct charitable contributions for which they receive state tax credits.

Conclusion

The proposed regulation is one of the first tax regulations reviewed by OIRA and subject to Executive Orders 12,866 and 13,563. As such, the regulation, the accompanying economic analysis, and the use of the analysis in regulatory decisions could help set lasting precedents for future tax regulations. Consequently, this comment reviews the regulation and accompanying analysis with special regard to key aspects of regulatory analysis articulated in Executive Order 12,866: problem analysis, alternatives, and assessment of benefits and costs.

The problem the NPRM identifies – new state tax credit programs that exist solely to facilitate avoidance of the SALT cap – is plausible, but further evidence is necessary to demonstrate that the problem is significant. Even assuming that the problem is significant, the proposed regulation is broader than necessary to address the problem. The regulation should focus on state tax credits that are SALT cap avoidance schemes and continue to allow deductibility for donations from taxpayers who are below the SALT cap and donations for legitimate charitable purposes. Finally, the accompanying economic analysis should assess the potential efficiency benefits from making each state's taxpayers bear more of the cost of their own state and local spending decisions, avoid claiming certain benefits that are not justified by economic analysis, and provide an empirical assessment of the likely costs of denying taxpayers below the SALT cap the ability to deduct charitable contributions for which they have received state tax credits.