
THE GEORGE WASHINGTON UNIVERSITY

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Public Interest Comment¹ on
Internal Revenue Service Notice 2019-12,

Guidance Providing a Safe Harbor Under Section 164 for Certain Individuals Who Make a Payment to or for the Use of an Entity Described in Section 170(c) in Return for a State or Local Tax Credit

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Jerry Ellig, Research Professor²

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) safe harbor notice 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

On June 11, 2019, the IRS published a guidance notice stating that certain individuals who receive state or local tax credits in exchange for contributions to or for the use of a charity or other entity described in section 170(c) can treat the contribution as a state or local tax payment. The Treasury Department and IRS requested comments on this Notice by July 11, 2019.³

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 Department of the Treasury, Internal Revenue Service, "Guidance Providing a Safe Harbor Under Section 164 for Certain Individuals Who Make a Payment to or for the Use of an Entity Described in Section 170(c) in Return for a State or Local Tax Credit," Notice 2019-12 (June 11, 2019). (Hereinafter "Notice.")

The IRS's 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. 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.

This rationale is sound, but there is an additional rationale rooted in the regulatory analysis principles of Executive Order 12866. Simply put, taxpayers below the SALT cap are not a source of the tax avoidance problem the IRS regulation is intended to solve. Without the Notice, the regulation is overly broad; it would penalize taxpayers below the SALT cap who choose to make contributions in exchange for tax credits instead of simply paying their state and local taxes. The Notice corrects this problem.

The IRS also speculates that a limited number of taxpayers would be affected by the Notice. Going forward, the IRS should use data to test this hypothesis by requiring disclosure of deductible state and local tax credits on Schedule A, using state data, or econometrically estimating the relationship between the number of taxpayers below the SALT cap who itemize deductions and the number of individuals who contribute to at least some of the programs or which states offer tax credits.

Justifications for the Safe Harbor

The IRS's Reasoning

The guidance is intended to remedy the potential for asymmetric treatment of state and local taxes and contributions for which individuals receive state or local tax credits. As the guidance notes, "These state tax credit programs effectively offer taxpayers a choice of paying tax to the state or local government or making a payment to a section 170(c) entity and receiving a tax credit that offsets the taxpayer's state or local tax liability."⁴ An individual who pays state or local taxes and itemizes can deduct those taxes, subject to the \$10,000 limit. In the absence of the safe harbor guidance, an individual below the \$10,000 SALT cap who made a contribution and received a state or local tax credit would lose the portion of the state and local tax deduction equal to the credit.

When individuals could claim such contributions as charitable deductions, the charitable deduction effectively gave back to the taxpayer the portion of the state and local income tax deduction that he or she lost because of the tax credit. But the IRS regulation published on June 11, 2019 prohibited individual taxpayers from taking a state and local tax deduction for

⁴ Id. at 5. (All page references refer to the version posted on the IRS web site on June 11, 2019.)

contributions for which the taxpayer received a state or local tax credit exceeding a de minimis amount.⁵

The economic analysis accompanying the final regulation demonstrates that if a taxpayer who is below the SALT cap cannot count such a contribution as a charitable deduction or a payment of state or local taxes, making a contribution in lieu of state or local taxes increases the taxpayer's federal tax liability by an amount equal to the taxpayer's marginal federal tax rate times the amount of the contribution.⁶ As the Notice states, "As a result of the ... regulations, if these individuals chose to make a payment to a section 170(c) entity instead of paying tax to the state or local government, they would lose a deduction to which they would otherwise have been entitled."⁷ The safe harbor in the Notice thus ensures that contributions for which individuals receive state or local tax credits are treated the same as individuals' state or local tax payments. They are deductible but subject to the cap on deductibility of state and local taxes.

An Additional Justification

There is an additional justification for the safe harbor, rooted in the regulatory analysis principles of Executive Order 12866. The Executive Order directs that the agency issuing a regulation "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,"⁸ "design its regulations in the most cost-effective manner to achieve the regulatory objective,"⁹ and "tailor its regulations to impose the least burden on society..."¹⁰

The regulation published on June 11 seeks to prevent taxpayers with state and local taxes exceeding the \$10,000 SALT cap from circumventing the cap. But the regulation is not tailored to impose the least burden on society, as Executive Order 12866 requires, because it curtails deductions for taxpayers below the SALT cap as well as for those above the SALT cap. Taxpayers below the SALT cap are simply not a source of the tax avoidance behavior the regulation seeks to prevent. The safe harbor in the Notice ensures that these taxpayers do not lose a tax deduction for which they are eligible simply because they choose to make a donation in lieu of a portion of their state or local tax liability.

⁵ Department of the Treasury, Internal Revenue Service, "Contributions in Exchange for State or Local Tax Credits: Final Regulations," RIN 1545-BP89 (June 11, 2019).

⁶ Id. at 55-56. (All page references refer to pagination of the version posted on the IRS web site on June 11, 2019.)

⁷ Notice at 5.

⁸ Executive Order 12,866, §1(b)(1).

⁹ Executive Order 12,866, §1(b)(5).

¹⁰ Executive Order 12,866, §1(b)(11).

Tracking the Effects of the Notice

It is not clear how many taxpayers would use the safe harbor or how much revenue would be affected. The Notice states the IRS's belief that this is a "small fraction" of taxpayers.¹¹ Going forward, the IRS should estimate these figures to track the effects of the Notice.

The most direct way would be to require taxpayers to report on Schedule A how much of their SALT deductions consist of contributions for which they received state or local tax credits. I can think of two other possible ways to estimate the number of taxpayers and amount of revenue involved without creating a new reporting requirement for individual taxpayers. 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.¹²

Conclusion

The regulation published on June 11, 2019 that prohibits taxpayers from taking a charitable deduction for donations for which they received a state or local tax credit addresses a plausible problem: new state tax credit programs that exist solely to facilitate avoidance of the SALT cap. But the regulation by itself is overly broad, because without the Notice it would have increased the federal income tax burden on taxpayers below the SALT cap who receive state tax credits in exchange for donations. These taxpayers are not a source of the problem the regulation seeks to solve. The safe harbor in the June 11 Notice corrects this problem by allowing individual taxpayers to classify donations for which they received state or local tax credits as state or local tax payments. Going forward, the IRS should track the effects of the Notice by requiring disclosure of deductible state and local tax credits on Schedule A, using state data, or econometrically estimating the relationship between the number of taxpayers below the SALT cap who itemize deductions and the number of individuals who contribute to at least some of the programs or which states offer tax credits.

¹¹ Notice at 4.

¹² 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/>.