IRS GUIDANCE ON TAX CREDIT PROGRAMS

Issue Brief

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Overview

New proposed rules from the Internal Revenue Service (IRS) mark a turning point in how the federal government views state tax credits. If implemented, the new rules will have a significant impact on tax-credit scholarship programs in several states.

Previously, taxpayers could donate to charities, receive a state tax credit, *and* claim a federal charitable deduction for the contribution. In some cases, this mechanism could result in donors lowering their overall tax bill by more than the amount contributed. This practice was completely legal, but many questioned the legitimacy of the policy. And many questioned the longevity of such a practice as more and more programs reaped a financial benefit from this quirk in federal tax policy.

The practice remained relatively under the radar for more than a decade, but the passage of the Tax Cuts and Jobs Act (TCJA) in December 2017 brought it into the spotlight. A major provision of TCJA is a new $10,000 cap on the amount of state and local taxes (SALT) that taxpayers can deduct from their federal taxes.

In states like New York, Connecticut and California, the average SALT deduction is nearly $20,000 – double the amount allowed under the new cap. In an effort to keep their citizens from feeling the pain of higher federal taxes, several states began proposing workarounds that mimic the same mechanics of existing tax credit programs: contribute to an organization, receive a large tax credit from the state *and* claim the contribution as charity on federal taxes.

On August 23, 2018, the IRS proposed new rules to address these workarounds. The rules require taxpayers to subtract the value of any state and local tax credits from their charitable deductions. In other words, if a $1,000 donation results in a credit that lowers state taxes by $1,000, a donor may not claim any of the $1,000 donation as a federal charitable deduction. If the $1,000 results in a $750 state income tax credit, only the remaining $250 can be deducted as a federal charitable contribution, and so forth.

The intent of the rule is to ensure that no charitable contribution results in a benefit larger than the amount of the contribution. This "quid pro quo" rule places state tax credits in the same legal position as gifts that one might receive for donating to a charity – such as subtracting the value of a four-course dinner from the donation at a charity gala, etc. The analysis below describes the issue, the potential impact on tax-credit scholarship programs, what school choice advocates are contemplating as next steps and Excel*in*Ed's position on the guidance.

Excel*in*Ed's position on the new IRS guidance

Excel*in*Ed advocates for state-based tax-credit scholarship programs that provide increased educational options for families. The proposed IRS rules close an unintended loophole that has allowed a small number of taxpayers to receive a greater tax benefit than the value of their donation. While we view the proposed rules as sound tax policy, we acknowledge that states with long-standing charitable tax credit programs may need a short transition period to adjust to the updated IRS guidelines. The demand for quality options in education remains strong. Given the strong mission of tax-credit scholarship programs, we are hopeful that the impact of this rule change on student scholarships will be minimal.

What are tax-credit scholarships?

Tax-credit scholarship programs incentivize individuals and businesses to donate to nonprofit organizations that provide tuition scholarships to eligible students. After making the donation, donors are eligible to receive a tax credit from the state. The credits typically range between 50% of the donation amount to a 100%, dollar-for-dollar credit.

Tax-credit scholarship programs currently exist in 18 states and serve around 260,000 students, the vast majority of which are low income. These programs are growing in popularity with parents and lawmakers, with half of the programs created in the past five years alone.

Typical interaction with federal taxes, pre-tax reform

For most taxpayers, it is not possible to donate to a scholarship organization, receive a state credit, and lower their overall tax bill by more than the amount donated. That is because most donations to a scholarship organization are offset by an equal reduction in the amount of state taxes they can deduct on their federal taxes.

Imagine a scenario in which someone living in Georgia pays $12,000 in state income tax. Prior to recent changes to the tax code, this individual could deduct the full $12,000 from their federal taxes.

If this individual gave $2,000 to a scholarship organization in the state, their state income tax owed would reduce to $10,000. Meanwhile, on their federal taxes, instead of fully deducting $12,000 in state taxes, they would deduct $10,000 in state taxes ***and*** $2,000 as a charitable deduction. **The taxpayer would still deduct $12,000. They just turned one $12,000 deduction into two deductions: a $10,000 state deduction and a $2,000 charitable deduction.**

AMT filers complicate the issue

The issue is more complicated for individuals who pay the Alternative Minimum Tax (AMT). The AMT was designed for higher-wealth individuals to ensure they pay a minimum level of taxes by eliminating many of the deductions available to standard itemizers.

Important for this context: AMT taxpayers are ***not*** allowed to deduct state and local taxes, but they ***can*** deduct charitable contributions from their federal taxes.

So, in the scenario outlined above, an AMT filer could not deduct *any* of their $12,000 in state taxes from their federal taxes. But, they could donate $2,000 to a scholarship organization to reduce their state taxes owed to $10,000 (which they would pay to the state) *and* deduct the $2,000 from their federal taxes as a *charitable contribution*.

Especially in states that provide 100% tax credits, this can result in donors receiving a greater overall tax benefit by including the donation as a federal charitable deduction on top of a dollar-for-dollar state credit. This is only possible in nine of the 18 states with tax-credit scholarship programs: Alabama, Arizona, Georgia, Montana, Oklahoma, Pennsylvania, Rhode Island, South Carolina, and Virginia.

Despite the *ability* for this to happen in theory, little information is available on how often this practice occurs.

Some states proactively addressed the issue

While it is not the responsibility of states to interpret federal tax policy for the IRS, some states proactively address the issue in state law. The Florida program, for instance, which has more than one-third of all tax-credit scholarship students in the nation, includes the following statutory language:

220.1875 Credit for contributions to eligible nonprofit scholarship-funding organizations.—

The credit granted by this section shall be reduced by the difference between the amount of federal corporate income tax taking into account the credit granted by this section and the amount of federal corporate income tax without application of the credit granted by this section.

Other state tax credits

It should be noted that dozens of other generous tax credits exist that are not related to private school choice. Here are a few examples:

- In Georgia, taxpayers can receive a 100% credit for donations to rural hospitals, with more than $60 million in credits available.
- In Oregon, taxpayers can receive a 100% credit for contributions of up to $1,000 to the Trust for Cultural Development Account, which use the donations to fund artists and other cultural endeavors.
- In South Carolina, taxpayers can receive a 100% credit for donations of up to $2 million to the Industry Partnership Fund at the South Carolina Research Authority, which uses funds "to provide incubation assistance, business services and marketing activities to start-ups" focused on technology.
- In Missouri, taxpayers can receive a 100% credit for contributions to the Missouri Agricultural and Small Business Development Authority, which uses the funds for financial or technical assistance to rural agricultural businesses.

The IRS previously sanctioned this process

While some commentators may have taken issue with the ability to lower one's overall tax bill by more than the amount contributed to a state tax program, there was nothing illegal with the practice.

Before the proposed rules were released, the closest guidance taxpayers had on the issue was a 2011 memorandum in which the IRS essentially sanctioned the ability for taxpayers to claim a federal charitable deduction for donations subsidized with state tax credits. While the IRS was clear that the memo should not be used or cited as precedent, there had not been any subsequent guidance contradicting this stance. So, as far as taxpayers knew, this practice is perfectly legal.

Changes to the Tax Code

The passage of the Tax Cuts and Jobs Act (TCJA) in December 2017 inadvertently supersized the incentive to donate to tax-credit programs by placing a cap on state and local taxes (SALT) that can be deducted from federal taxes.

Before TCJA, individual taxpayers could deduct all of their state and local taxes when calculating their federal taxes. In other words, if a taxpayer owed $12,000 in state income tax in 2017, they could deduct the full $12,000 from their federal taxes. However, TCJA caps state and local deductions at $10,000. That means that the same taxpayer who could deduct $12,000 in 2017 can only deduct $10,000 in 2018 and beyond.

The new cap on SALT deductions creates the same incentives that exist for AMT filers and tax-credit program donations. A taxpayer in Georgia who owes $12,000 in SALT taxes can lower their overall tax burden by contributing $2,000 to a scholarship program, lower their state taxes to the cap of $10,000 and still deduct $2,000 from their federal taxes as a charitable contribution.

States with high taxes respond

The reason Congress chose to limit SALT deductions to $10,000 per person is fairly evident: Congress did not want to continue subsidizing states that levy high taxes on their citizens. For instance, according to the Pew Charitable Trusts, 35 percent of New Yorkers claim a SALT deduction with an average of $22,169 in state and local taxes per claimant. Meanwhile, only 19 percent of taxpayers in Tennessee claim a SALT deduction, with an average claim of just $5,612. Comparing these two states, one could interpret federal SALT deduction as a subsidy for higher-tax states at the expense of citizens in states with lower taxes.

But in response, many higher-tax states (California, Connecticut, New Jersey, etc.) proposed state loopholes to keep their citizens from feeling the effect of tax increases. For instance, a California bill proposed the creation of a "California Excellence Fund," which would essentially provide a large state tax credit to individuals who donate to a "nonprofit" that collects money for public projects.

Essentially, these proposals would mimic the mechanics of tax-credit programs to enable the state to continue to pay for projects while giving their citizens the ability to lower their state taxes via a large credit while *also* allowing them to claim the donation as a federal charitable contribution. In other words, it would keep residents from feeling the effect of the new $10,000 cap on SALT deductions.

IRS responds with new rules

On August 23, 2018, the IRS issued highly anticipated rules to address the new state workarounds. The proposed guidance implements a "quid pro quo" rule, which requires taxpayers to subtract the value of state and local tax credits from their charitable deductions. For example, if a $1,000 donation results in a credit that lowers state taxes by $1,000, a donor may not claim any of the $1,000 donation as a federal charitable deduction. If the $1,000 results in a $750 state income tax credit, only the remaining $250 can be deducted as a federal charitable contribution, and so forth.

This requirement treats donations for state tax credits much like other areas of tax law, which require taxpayers to subtract the "fair market value" of goods or services received in exchange for a contribution. For instance, if a donor receives $25 worth of DVDs for a $100 donation to their local PBS affiliate, the donor must subtract the $25 gift from the $100 donation when itemizing their deduction.

These new proposed rules will apply to all state and local tax credits – not just the workarounds created by states.

A major drop in the number of AMT filers

Another, less-reported issue is the fact that the total number of AMT filers will decline dramatically as a result of TCJA. While there were an estimated 5.25 million AMT filers in 2017, the number will fall to around 200,000 moving forward – a 96 percent drop.

The reason is threefold: higher AMT exemptions, a phasing out of levels and fewer tax breaks that previously served as a trigger for the AMT. As a result, the estimated 200,000 AMT filers in the future are likely to be the highest income households in the nation, with very complex tax structures.

If it is true that AMT filers are the most incentivized to give to state tax-credit programs across the country, then a 96 percent drop in AMT taxpayers may have as big an impact on these programs as the new quid pro quo requirement.

The IRS is seeking input on the proposed regulations

The IRS is holding a public hearing on the proposed rules on November 5 at the Internal Revenue Building, 1111 Constitution Avenue, N.W., Washington, DC 20224. The IRS is also seeking public comment on the rules, due by October 11 (45 days after the proposed regulation was posted). Those interested in providing comments, as well as those wishing to speak at the hearing, must send submissions electronically or via mail:

- Comments can be sent electronically via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-112176-18).

- Written submissions should reference "REG-112176-18" and be sent to:

  Internal Revenue Service
  Room 5203
  P.O. Box 7604
  Ben Franklin Station
  Washington, DC 20044

Opinions within the private school choice advocacy community

There are diverging opinions from the school choice community on how to react. It is hard to argue that the quid pro quo rule is overtly unfair in this context. Yet, the proposed rules and a dramatic drop in AMT filers may lead to fewer scholarship dollars for students in some states – although the true impact may not be evident until the close of the 2019 fiscal year.

Another wrinkle is that not all programs will be impacted. As mentioned previously, Florida's program has had statutory language for years that prevents donors from receiving a benefit that exceeds their contribution. The fact that more than one-third of all tax-credit scholarship students participate in a program that will likely see little impact from the proposed IRS rules challenges the notion that programs are fundamentally handicapped by the quid pro quo rule.

It is also not clear what impact, if any, the rules will have on **corporate donations**, since the benefit of the charitable deduction has only applied to individual taxpayers in the past. However, there could be nuances of federal taxation that will also lead to drops in corporate giving as well.

A handful of responses, described below, have been suggested by school choice advocates: oppose the new rules, allow for an adjustment period via delayed implementation, and accept the new rules as written.

Oppose the new rules. Many in the school choice community believe that the new rules are flawed and should be re-written to protect tax-credit scholarship programs. Three policy approaches have been discussed to oppose the rules:

Grandfather pre-existing programs. Some argue that because these programs already exist – many for more than a decade – they deserve to be able to continue operating without the quid pro quo requirement.

Carve out programs that meet certain societal goals. Some argue that certain actions – like providing scholarships to needy children, funding rural hospitals, etc. -- deserve to benefit from incentives that allow for donors to receive a benefit greater than their contribution.

Distinguish between true charities and obvious workarounds by state governments. Many of the workarounds proposed by states are packaged as "charities," but in reality are either controlled by a government agency or are designed to collect money for public projects. Some have suggested that the IRS could distinguish between true nonprofit charities – like 501(c)(3) organizations that provide scholarships to students -- and organizations that have connections to the state.

Delay implementation of the new rules. Since there are many nonprofit organizations and sectors dependent on these donations to provide services, many have argued that a phased-in implementation should take place to allow pre-existing organizations to adjust to the changes. Especially since the 2011 IRS memo temporarily condoned the practice. Granting existing organizations extra time would allow them to solicit new donors, phase out services that can no longer be provided, and lay off employees to adjust to smaller budgets.

Accept the new rules. For some, the rules proposed by the IRS are fair and good policy. While accepting the policy may cause short-term pain for some programs, the rules may benefit these programs in the long run by removing this loophole and ensuring that the true purpose of these programs is reinstated. Instead of depending on donations based on CPA recommendations to save on taxes, the programs could focus more on telling the story of the students or hospital patients or others who benefit and focus their fundraising efforts on those who believe in the mission. This has worked in states like Florida and Illinois where state law has prevented donors from receiving a benefit greater than a contribution.

Conclusion

It is our opinion that a short-term delaying of the rules for existing organizations to adjust to the new context, while fully accepting the new rules as good and sound policy, is the best path forward.

No tax-credit scholarship program was designed to help donors save on their tax bill. Instead, they were designed by state lawmakers to allow taxpayers to direct some portion of their tax bill toward a cause they believe in – providing schooling options to meet student needs. Just like no school choice supporter would advocate for a 130% state tax credit, neither should we push to preserve a loophole in the federal tax code that allows donors to turn a $1,000 donation into $1,300 in lower taxes.

While this rule may cause some short-term transition issues, we believe that these programs can rise to the challenge by focusing their fundraising efforts on donors who believe in the cause. This should be easiest in states with 100% credits, where donors feel no financial pain for directing to this worthy cause. States with lower credit amounts – perhaps set low to prevent the very action that the IRS is fixing – have an opportunity to consider raising their credits to 100% to ensure that students are not left without scholarships as a result of higher tax burdens for donors.

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