
How Are States Responding to the Tax Cuts and Jobs Act?

Treasury/IRS Responses to State and Local Changes

Charitable Contributions

Notice 2018-54 (May 23, 2018)

- Announced IRS intention to proposed regulations addressing the tax treatment of transfers to funds controlled by state or local governments (or state-specified transferees) that the transferor can treat in whole or in part as satisfying state and local tax obligations.
- The proposed regulations will be informed by substance-over-form principles and will make clear that the requirements of the IRC govern, regardless of the characterization of the payments under state law.

IRS Press Release (May 23, 2018) accompanying Notice 2018-54:

Treasury/IRS are continuing to monitor other legislative proposal to insure that federal law controls characterization of deductions for federal income tax filings.

Proposed Reg. 1.170A-1(h)(3) and 1.642(c)(3)(g) – Contributions in Exchange for State and Local Tax Credits

- Proposed Quid Pro Quo rule will apply to all state and local tax credits to reduce charitable contributions.
 - Departs from prior practice.
 - Proposed Regulation applies to all state and local tax credit programs, including conservation easements and school choice programs.
- Tax Credits: Charitable contributions are reduced by the amount of any state or local tax credit that the taxpayer receives or expects to receive in consideration for the taxpayer's payment or transfer.
 - State and local tax credits need not be provided by donee organization.
- State and Local Tax Deductions: If the state or local deduction exceeds the payment or fair market value of property transferred, charitable contribution deduction is reduced.
- 15% De Minimus Rule: If state or local tax credit received or expected to be received does not exceed 15% of payment or fair market value of property transferred, then no reduction in charitable contribution deduction. [Note: The de minimus rule does apply to deductions]
- Proposed Quid Pro Quo Regulation only applies to charitable deductions under Section 170. It does not to other code provisions: 61, 162, 1001.

Proposed Reg. 1.170A-1(h)(3) and 1.642(c)(3)(g) – Contributions in Exchange for State and Local Tax Credits (cont'd)

- Numerous comments from supporters of legacy credit programs and new programs.
- Timing of final regulations.
- Expect challenges to final regulations.

Transforming Charitable Contributions into Trade or Business Expenses Deductible under Sec. 162

- IRS News Release (IR-2018-178) Sept. 5, 2018 and FAQ.
 - IRS “clarified” that business related payments to charities or government entities for which taxpayers receive state or local tax credits can generally be deducted as business expenses under Sec. 162 if the payments are made with a business purpose.
 - The business expense deduction is available to a taxpayer engaged in carrying on a trade or business, regardless of the form of the business, a sole proprietorship, partnership or corporation, as long as the payment qualifies as an ordinary and necessary business expense.
- Secretary Mnuchin released a coordinated statement: “The recently proposed rule concerning the cap on state and local tax deductions has no impact on federal tax benefits for business-related donations to school choice programs.”

Safe Harbor Business Expense Rule – Rev. Proc. 2019-12 (Dec. 27, 2018)

- Rev. Proc. does NOT apply quid pro quo approach of proposed regulations. Rather, it interprets Regulation 1.170A-1(c)(5) that provides transfers to a charitable organization that bear a direct relationship to the taxpayer’s trade or business and that are made with a reasonable expectation of financial return commensurate with the amount of the transfer may constitute a trade or business deduction deductible under Section 162, rather than a charitable contribution.
 - What is a “direct relationship” and “reasonable expectation”?
- Rev. Proc. provides: for a C corporation to the extent that a state or local tax credit can reduce the C corporation’s tax liability, “it is reasonable to conclude that there is a direct benefit” in the form of a reduction in state or local taxes that the C corporation would otherwise have to pay and to the extent of the credit, there is a reasonable expectation of financial return to the C corporation commensurate with the amount of the transfer.
- Rev. Proc. provides: for a pass-through entity that is separate from its owner, the C corporation standard above for “direct relationship” and “reasonable expectations” applies, except the deductibility of the payment must be determined at the level of the individual owners of the entity if the credit received or expected to be received will reduce a state or local income tax subject to limitations in Section 164(b)(6).
- Rev. Proc. provides Section 162 safe harbors only for payments made by C corporations, S corporations and partnerships. Safe harbor does NOT apply to single member LLCs or sole proprietorships.

Safe Harbor Business Expense Rule – Rev. Proc. 2019-12 (Dec. 27, 2018) (cont'd)

- C corporation safe harbor. Section 3.02. If a C corporation makes a payment to or for use of a charity and receives or expects to receive a tax credit that reduces state or local tax imposed on the C corporation in return for such payment, the C corporation may treat the payment as meeting the requirements of an ordinary and necessary business expense for purposes of Section 162 to the extent of the credit received or expected to be received.
- Pass-through entities separate from its owner's safe harbor. Section 4.02.
 - Entity must operate a trade or business.
 - Entity is subject to state or local tax incurred in carrying on its trade or business that is imposed directly on the entity.
 - In return for a payment to a charity, entity receives a state or local tax credit that the entity applies or expects to apply to offset a state or local tax described above, other than a state or local income tax.
 - Examples involve credits that reduce excise taxes and property taxes incurred in carrying on the entity's trade or business.
- Rev. Proc. confirms multiple deductions are NOT allowed.

Entity Level Tax and Employer Wage Compensation Program

- Legislative History, including Blue Book:

Taxes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in a partner's or S corporation shareholder's distributive or pro-rata share of income or loss on a Schedule K (or similar form) will continue to reduce such partner's or shareholder's distributive or pro-rata share of income as under present law.

- Treasury/IRS Business Plan (Nov. 8, 2018): “Guidance on applying the state and local deduction cap under Sec. 164 (b)(6) to passthrough entities.”

- Awaiting guidance.



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