Charitable Contributions in Lieu of SALT Deductions

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California and other states are considering new charitable tax credits to do end runs around the 2017 federal tax overhaul’s cap on state and local tax deductions. Will these plans work?

Yes, but with some qualifications. Along with seven other tax law professors, I am a coauthor on a draft essay arguing that federal law enables states to offer tax credits for charitable contributions to state programs in a manner that could circumvent the SALT deduction cap. While I obviously agree with the essay’s analysis, my views are not fully explicated, which is where this follow-up comes in.

First, I should specify what we are talking about. It is helpful here to distinguish between (1) what I will call the “aggressive way” to structure a state-level tax credit of that sort, and (2) what I will call the “smarter way” to do so.

The aggressive way to structure this plan is for a state to offer a 100 percent tax credit for charitable donations to the state’s general fund. The goal here is to incentivize state residents whose federal-level deductions for state-level taxes will be capped to instead make charitable contributions to the state government to reduce their state-level taxes. Under current law, voluntary donations to state general funds qualify for the federal-level charitable contribution deduction. Thus, this plan would allow state residents to effectively transform nondeductible state-level tax payments into fully deductible charitable contribution deductions to the state.

The smarter way to do that would be for a state to offer a less than 100 percent credit for charitable donations to funds set up for specific state programs, with a cap on the total amount creditable per taxpayer. For instance, a state might offer a 90 percent credit for donations made to a fund to support public colleges and universities with the state. A state could set up multiple funds to offer choices as to which programs residents want to support.

Note here that a 90 percent (or lower) credit would still enable participants to come out ahead after tax for making a qualifying donation. If a taxpayer in the new 24 percent federal income tax bracket were to make a $100 qualifying charitable contribution through such a program, that taxpayer would save $90 of state-level taxes and $24 of federal-level taxes. The full after-tax return would thus be $114 of combined tax savings from the $100 contribution.

Do those plans work under federal law? The answer is clearly yes, at least in the sense that existing legal authorities overwhelmingly support them working. Indeed, many states already offer credits for charitable contributions of that sort,


with the credit amount reaching 100 percent in some cases.\(^3\) As our group essay explains in greater depth, the IRS has blessed these programs (albeit with low-level guidance), and numerous judicial decisions also support taxpayers’ receiving full federal-level charitable contribution deductions for donations to these programs.\(^4\)

Of course, it is possible to distinguish the legal authorities that support these plans. Thus, the IRS could perhaps justify challenging newly enacted plans, especially for plans structured more like the aggressive way than the safe way. But the IRS would face an uphill battle in challenging these plans based on existing legal authorities.

A more complicated and interesting question is who has the power to change that aspect of federal tax law. Congress clearly has the authority to revise it through legislation that would deny federal-level charitable contribution deductions for donations to these programs.

But do Treasury and the IRS have the power to revise that aspect of federal tax law absent new legislation? My view is that they could through exercise of their regulatory authority — that is, by issuing a new Treasury regulation. However, it’s less clear whether the IRS could change that aspect of federal tax law on its own, without using the Department of the Treasury’s regulatory powers.

With all of that in mind, should states design new programs and, if they do, how should Treasury and the IRS respond? These nuanced questions lack clear and straightforward answers. In contrast to at least some of my group essay coauthors, I consider the prior federal-level SALT deduction to be suboptimal federal policy\(^5\) and would favor well-designed approaches to cap or eliminate it. However, the new federal-level cap is poorly designed.

In particular, I worry that by capping the federal deduction for state and local personal income taxes, while leaving business-level deductions for state and local taxes mostly uncapped — especially deductions for state corporate income taxes — the new law will incentivize states to shift their revenue-raising from personal to corporate income taxes. My concern then is that the negative consequences from that tax shift will ultimately overpower any positives of capping the federal deduction for state and local personal income taxes.

A more comprehensive evaluation of the policy concerns and tradeoffs regarding these questions is beyond this essay’s scope. But even for those who — like me — would support capping federal SALT deductions in the abstract, there are reasons to fear that the new federal cap on these deductions might do more harm than good.

Moreover, regarding the question of how state governments should act, it must be recognized that they primarily have a duty to their residents and only secondarily to federal policy concerns. Of course, cooperation among states and between states and the federal government is important. In other scenarios, the merits of promoting cooperation should perhaps trump a state’s desires to act in the narrow interests of its residents.

Yet in the scenarios we are faced with, states have been subjected to new federal legislation that was rushed through in a secretive, highly partisan manner.\(^6\) In these circumstances, it seems reasonable for states like California and New York to respond with measures that promote the interests of state residents over arguably countervailing national interests regarding cooperation.

By contrast, Treasury and the IRS are charged with promoting the national interest regarding tax policy and tax design. With that in mind, should Treasury and the IRS then use their regulatory powers to combat state-level efforts of that sort?

One reason for Treasury and the IRS to be cautious is that there are serious administrative concerns that would follow from how either might use its regulatory authority for those purposes. My essay coauthors are working on a

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\(^3\) For a list and explanation of current state-level programs of that sort, see Appendix A of Bankman et al., supra note 2.

\(^4\) Id.

\(^5\) My views can be found in Gamage and Darien Shanske, “Tax Cannibalization and Fiscal Federalism in the United States,” 111 Nw. U. L. R 295 (2017).

\(^6\) See Samuel A. Donaldson, “Understanding the Tax Cuts and Jobs Act” (Jan. 8, 2018) (“the Tax Cuts and Jobs Act was the product of a deeply partisan and largely closed-door process”).
follow-up to explain those problems, so I will not elaborate here.

Another reason for Treasury and the IRS to refrain from using regulatory authority, at least regarding the smarter way design, is that states might then respond with other approaches to effectively preserve the benefits of the federal SALT deduction. Along with another set of coauthors, I explain some of these approaches in two other draft essays. We are currently revising and explaining the arguments in those essays to submit for publication.

Considering the myriad options available to states, Treasury and the IRS ultimately lack the power to prevent them from acting to preserve the benefits of the prior SALT deduction. Doing so effectively would require new, better drafted federal-level legislation. For instance, Daniel Hemel has described other approaches that states could take in “States and Localities Can Offset Federal Tax Law’s Impact on Their Residents.” And at the extreme, no regulatory authority would enable Treasury or the IRS to prevent state governments from just shifting away from the use of personal income taxes and toward the use of (fully deductible) corporate income taxes.

Again, fully evaluating these possibilities is beyond the scope of this article. For here and now, my conclusions are just the following:

1. Under current federal law, the smarter way design should work.
2. Treasury and the IRS have the regulatory authority to change that aspect of federal law.
3. However, absent new federal legislation, there are persuasive policy reasons for Treasury and the IRS to refrain from issuing those regulations.
4. Ultimately, new federal legislation is needed to fix the flawed cap on federal SALT deductions.

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