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Tax Law:
Problems with Abandoning the Full-Deduction Rule

Manoj Viswanathan

Introduction

In 2018, several states considered tax-credit programs that would reduce state tax liability based on donations made by a taxpayer in support of various state programs. In general, taxpayer contributions to qualifying organizations—including public charities, private foundations, and federal, state, local, and tribal governments—are eligible for the federal charitable-contribution deduction under 26 U.S.C. § 170. Law and IRS guidance prior to August 2018 supported the view that qualifying charitable contributions are deductible under § 170 (the “full-deduction rule”) even when the donor derives some federal or state tax benefit by making the donation. In August 2018, the IRS issued proposed regulations scrapping this full-deduction rule. Even assuming that the IRS has the legal authority to implement these proposed regulations, they present legal and administrative concerns.

Background

Section 170(c) defines the phrase “charitable contribution” to include not only gifts to conventional nonprofit entities but also “a contribution or gift to or for the use of a State, a possession of the State, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.” In general, when a donor receives some benefit, either directly or indirectly, from making an otherwise qualifying charitable contribution, the amount of the deduction under §

1. Summarized and excerpted from Joseph Bankman, David Gamage, Jacob Goldin, Daniel Hemel, Darien Shanske, Kirk J. Stark, Dennis J. Ventry, Jr., & Manoj Viswanathan, Caveat IRS: The Problems with Abandoning the Full Deduction Rule, SPECIAL REPORT, TAX NOTES (May 7, 2018). Content in this piece addressing the August 2018 proposed IRS regulations is the work of Manoj Viswanathan and does not necessarily reflect the views of the coauthors of the original piece; all errors in those portions are his own.
170 is reduced by the value of that benefit.\textsuperscript{4} To the extent of the benefit received, the donor’s contribution is treated as arising from uncharitable impulses and is thus not deductible as a charitable gift.

These rules have considerable intuitive appeal. Without them, taxpayers could easily convert nondeductible personal consumption into deductible charitable gifts. Nevertheless, the law has not treated the tax benefits of charitable giving as the type of benefit that requires a reduction in the amount of the donor’s charitable-contribution deduction. Indeed, in the century-long history of the federal charitable-contribution deduction, no taxpayer has ever been required to reduce the amount of her deduction by the value of tax benefits generated by making a gift. Instead, the law disregards the tax consequences of charitable giving in determining the amount of a charitable-contribution deduction.\textsuperscript{5} This rule applies to all tax benefits—federal, state, and local—and regardless of whether the taxes reduced would have been deductible.

In August 2018, the IRS retreated from this long-standing precedent and issued proposed regulations stating that charitable contributions are now “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.” These proposed regulations treat any state tax credit and certain excessive state income-tax deductions obtained from making a federal charitable contribution as a federal deduction-reducing quid pro quo.\textsuperscript{6}

This abandonment of the full-deduction rule would cause two sets of administrative complexities. The first concerns difficulties in determining the appropriate amount of the donor’s deduction for state tax credits received. The second concerns difficulties associated with the donor’s receipt of “excessive” state income-tax deductions. Any attempt to eliminate or limit the operation of the full-deduction rule will have to overcome both issues, which the proposed regulations are not able to do.

Problems with Limiting the Full-Deduction Rule

A major advantage of the full-deduction rule is its administrative simplicity. The amount of the taxpayer’s charitable contribution deduction is simply the amount of cash or the fair market value of

\begin{itemize}
  \item[4.] Treas. Reg. § 1.170A-1(h)(2)(i).
  \item[5.] \textit{See}, \textit{e.g.}, Skripak v. Commissioner, 84 T.C. 285 (1985).
\end{itemize}
property donated. By contrast, eliminating the full-deduction rule would make it difficult—and in some cases impossible—for taxpayers and the IRS to compute the proper deductible amount for charitable contributions. The complication arises because the analytically proper deductible amount of a contribution (absent the full-deduction rule) would depend on the value of the tax benefits that the contribution creates. At the same time, the tax benefits that flow from the contribution often depend upon the amount of the contribution that is deductible by the taxpayer. The resulting circularity makes it difficult to calculate the correct amount of a taxpayer’s contribution deduction. This circularity—and the resulting complications—is avoided as long as the full-deduction rule remains in place.

The dollar value of a state income-tax deduction is not obvious. Attempting to determine this value for quid pro quo purposes results in a circularity problem—the value of the state income-tax deduction is a function of the taxpayer’s state marginal tax rate, but the taxpayer’s state marginal tax rate depends on her state taxable income. In several states, the taxpayer’s state taxable income is determined directly by reference to her federal taxable income, which of course depends on the amount of the federal deduction allowed. In these states, abandonment of the full-deduction rule will make it impossible to determine the amount of the taxpayer’s federal charitable-contribution deduction without knowing the amount of her federal charitable contribution. For states that base a resident taxpayer’s income on her federal adjusted gross income and conform to federal rules for determining the amount of the taxpayer’s charitable-contribution deduction, determining her state marginal tax rate (and thus the value of her state charitable tax benefit) would be similarly unknowable because, again, the amount of the federal charitable contribution and the value of the state tax benefit is required to determine the other. The August 2018 proposed regulations provide no additional clarity on this issue, stating only that, in the case of state income-tax deductions greater than the fair market value of the contributed property, that “the taxpayer’s charitable contribution deduction under section 170 [will be] reduced.”

Even if the taxpayer’s state marginal tax rate could be determined (for example, if the state’s income tax features a single flat rate), new difficulties in computing the proper amount of the federal charitable-contribution deduction would arise for any state that did not adopt the same rule as adopted by federal authorities. For example, consider a taxpayer who makes a $1,000 contribution to an organization eligible to receive deductible charitable contributions under § 170. Assume further

that the taxpayer is subject to a 37% federal marginal tax rate and a 10% state marginal tax rate. If a state awarded a 200% deduction for this charitable contribution, this would trigger the quid pro quo rules of the August 2018 proposed regulations. This would also imply a combined (federal and state) tax benefit of $570 ($370 federal and $200 state). Because of the circularity problem referenced above, however, an algebraic formula would be needed to determine the appropriate deductible amount. But each state would be free to continue applying the full-deduction rule and thereby allow our hypothetical taxpayer a charitable-contribution deduction for the full $1,000 for purposes of determining her state income-tax liability, even though some states may choose to follow the (presumed here) new IRS abandonment of the full-deduction rule. Thus, different algebraic formulas would be needed for different states depending on whether the state follows the IRS in abandoning the full-deduction rule or preserves it.

Additional complexities arise in the case of state tax credits. The proposed regulations state that the charitable-contribution deduction is reduced by any state tax credit awarded. At first blush, the proposed regulations’ approach of requiring taxpayers to reduce the amount of their federal charitable-contribution deductions by the value of any state charitable tax credits to which they are entitled seems straightforward—generally, credits are not taken into account in determining the amount of the taxpayer’s taxable income, but rather are subtracted from the taxpayer’s preliminary or tentative tax liability to determine her actual final tax liability. Thus, in theory, it should be easier to determine the value of a state tax credit for purposes of requiring taxpayers to reduce the amount of their federal charitable-contribution deductions by that value. In practice, however, state charitable tax credits incorporate many different features that complicate the determination of the amount of the credit available to the taxpayer. For example, state charitable tax credits commonly include: (1) state-law limitations on the amount creditable, so that only a portion of the taxpayer’s total gift is creditable, (2) different state-law limitations depending on the taxpayer’s filing status, (3) varying state-law credit percentages depending on the total value of the gift or whether contributions were made in consecutive years, (4) different state-law rules in terms of the priority of the available credit relative to other credits, and (5) different state-law rules regarding whether unused credits can be carried forward and the number of years after which any unused credits will expire. Some of these features of state law would complicate the determination of the value of the credit to the taxpayer more than others, but all have the characteristic of rendering the actual
value of the credit unknowable until the taxpayer has filed her state income-tax return for the year in which the credit is applied.

This last point deserves emphasis because of its relevance to any charitable tax incentive, no matter what form it takes. For both deductions and credits for charitable gifts, presumably the donor has a ballpark sense of the value of the tax incentive at the time of the gift. Indeed, the donor’s awareness of the ballpark value of the tax incentive may be an important factor in her decision to make the gift in the first place. Because of the way tax systems work, however, the taxpayer will not know the actual effect of a deduction or a credit on her state tax liability until she files her state tax return. The taxpayer cannot file a state tax return until after the end of the tax year in which the contribution is made, and typically does not file it until the federal return has already been completed. Because knowing the value of state tax benefits is necessary to determine the proper amount of the federal deduction, any effort to abandon the full-deduction rule would require taxpayers to complete their state returns before completing their federal returns. However, because state income taxes typically use federal-law determinations (for example, adjusted gross income or taxable income) as a starting point for calculating state income-tax liability, it is necessary for taxpayers to have already made these determinations before turning to their state tax returns.

Additional complexity is created for tax credits that are transferable. If the value of the state credit does not affect the federal treatment of the size of the charitable contribution because the credit reflects a reduction in state tax liability, as under prevailing law, a taxpayer has no basis when she transfers the credit.\(^8\) If the taxpayer were to have the value of her federal contribution reduced in some way because the credit represents income, then she would have a basis in her transferable state credits. The complexities discussed above would come into play in calculating this basis, heightened by the more complicated tax situations of many businesses that use these credits. Further, the basis would have to be tracked, potentially through multiple taxpayers. It is worth noting that making credits transferable is commonly viewed as efficiency enhancing. Indeed, there is a significant market in transferable credits, so altering how to account for their basis would be a considerable—and complicated—change.

Conclusion

It should be clear from the foregoing that the full-deduction rule enjoys the benefit of administrative simplicity. Under the full-deduction rule, the only information required to determine the charitable-contribution deduction is the amount of money or value of the property donated to a qualifying donee. Neither the taxpayer nor the IRS need inquire into the federal, state, or local tax benefits arising from the gift. The August 2018 proposed regulations, by abandoning the full-deduction rule, introduce substantial complexity without accurately applying existing quid pro quo doctrine.

The proposed state contribution-credit programs, if enacted, could reduce the revenue that the federal government expected from capping the state and local tax deduction in the Tax Cuts and Jobs Act. At the same time, the IRS, with the stroke of its pen, cannot regulate away all unexpected consequences of the new tax law. For state contribution-credit programs, it is worth noting that millions of taxpayers subject to the AMT in 2017 could have taken—and did take—advantage of more than 100 contribution-credit programs in more than 30 states to receive charitable deductions that offset “lost” SALT deductions. These programs were, and remain, grounded in long-standing tax law, respected by the IRS and the courts.9 For similar reasons, the full-deduction rule is a sound rule of tax administration. The proposed regulations, by restricting the full-deduction rule, tread on uncertain legal and practical grounds.