

# **The Power Not to Tax**

## **State Responses to TCJA 2017**

**(with particular emphasis on California)**

**Kirk J. Stark**

**Barrall Family Professor of Tax Law and Policy**

**UCLA School of Law**

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# TCJA: Revenue Effects of Key Provisions: 2018-27

- 21% Corporate Rate — **\$1.3 trillion**
- Lower Individual Rates — **\$1.2 trillion**
- Standard Deduction — **\$ 720 billion**
- “Pass-through” Deduction — **\$ 415 billion**
- Child Tax Credit — **\$ 573 billion**
- Limit Itemized Deductions + **\$ 668 billion**
  - *Incl. \$644 billion from \$10k limit on SALT deduction*

- **SALT deduction: 1913-2017**

***26 U.S.C § 164(a) – Deduction for State and Local Taxes***

(a) General Rule: Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued: real property taxes, personal property taxes, income (or sales) taxes

***26 U.S.C § 56(b)(1)(A)(ii) – No Deduction for State/Local Taxes for AMT (1986 on):***

“In determining the amount of the alternative minimum taxable income of any taxpayer (other than a corporation)... No deduction shall be allowed ... (ii) for any taxes described in paragraph (1), (2), or (3) of section 164(a) or clause (ii) of section 164(b)(5)(A).

- **SALT deduction: 2018-2025**

***26 U.S.C § 164(b)(6) – \$10,000 Limit on Deduction for State and Local Taxes***

(6) ... In the case of an individual and a taxable year beginning after December 31, 2017, and before January 1, 2026—

(A) foreign real property taxes shall not be taken into account under subsection (a)(1), and (B) the aggregate amount of taxes taken into account under paragraphs (1), (2), and (3) of subsection (a) and paragraph (5) of this subsection for any taxable year ***shall not exceed \$10,000*** (\$5,000 in the case of a married individual filing a separate return).

# Tax Price Effects of Nondeductibility

- California's top marginal PIT rate is currently 13.3%
- Pre-TCJA, an itemizing taxpayer facing the top federal marginal rate of 39.6% would not bear the full burden of the 13.3% state rate because of the SALT deduction.
- Effective state marginal rate was  $13.3\% \times (1 - .396) = 8.03\%$  rate.
- Post-TCJA, California taxpayers face an effective **13.3%** rate.
- Above \$10,000 cap, State/Local taxes now treated:
  - Same as personal consumption (e.g., personal masseuse)
  - Worse than, e.g., charitable contributions, home mortgage interest.
- New Post-TCJA Calculus:
  - Federal law disfavors collective investment in state/local public goods via taxes.
  - No indication that demand for state/local public goods has diminished.

# State Responses

- ① **Challenge Constitutionality** – NY, NJ, MD, CT
- ② **Payroll tax option** – NY  
new wage tax on employers, coupled with a reduction in employee income taxes (via credit); a corresponding reduction in gross wages
- ③ **Pass-through tax** – CT  
new entity level tax on LLCs, partnerships, coupled with a reduction in pass-through owners' income taxes (via credit)
- ④ **Charitable tax credit option** – CA, **CT**, DC, IL, IN, MD, NE, **NJ**, **OR**, **NY**, VA, WA  
establish new charitable funds to support state/local expenditure functions – provide nonrefundable credit of X% for donations



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# Generic Description of the Legal Issue

- ***Expected Tax Liability = \$X***
  - Taxpayer expects to owe \$X in tax for 2018.
- ***Transfer to Qualifying Entity = \$F***
  - Taxpayer transfers \$F as a charitable contribution to some non-profit/government entity [see 26 U.S.C. §170(c)]
- ***Tax Benefit Derived from Transfer = \$T***
  - government (federal, state, local) provides that those making such transfers are entitled to claim some tax benefit \$T [deduction/credit, a function of \$F] in determining tax liability.
- ***Age Old Question: Deduct \$F or Deduct \$F - \$T?***

# Age Old Answer to Age Old Question

**\$F**

***“Full Deduction Rule”***

**1917 - ?**

***The amount of a taxpayer’s charitable contribution deduction is the full amount donated, undiminished by the federal, state, or local tax benefits the taxpayer is entitled to by virtue of making the gift***



# “Full Deduction Rule” Illustrated

- Jessa expects to owe \$90,000 in tax to South Carolina
- Only \$10,000 of this amount will be deductible on her federal return because of new SALT limits of §164(b)(6)
- Jessa donates \$50,000 to the “Exceptional SC Fund” (a 501(c)(3) entity established by the state legislature to receive donations to fund tuition scholarships to private schools).
- Under South Carolina law, Jessa is entitled to a \$50,000 state income tax credit. As a result of this credit, her *actual* state income tax liability is \$40,000.

***May Jessa deduct the full \$50,000 donated to Exceptional SC on her federal return?***

## Nonrefundable Tax Credits for Exceptional SC Donations:

As of December 21, 2017 at 8:00 am:

**Donations to Exceptional SC:** \$8,826,646.03

**Available Tax Credits for Donors:** Approximately \$2,173,353.97

Anyone can donate to the Exceptional SC 501(c)(3) scholarship fund, which provides scholarships to exceptional needs students. Individuals and corporations who pay South Carolina taxes can make a donation to Exceptional SC and claim a dollar for dollar tax credit against their overall South Carolina income tax liability (personal corporate income tax). Donors can deduct contributions made to Exceptional SC on their federal income taxes under IRC Section 170.

A taxpayer may not claim more than sixty percent of his total South Carolina tax liability for the year the contribution was made. If a taxpayer deducts the amount of the contribution on his federal return and claims the nonrefundable credit, then he must add back the amount of the deduction for South Carolina income tax purposes.

### Donors are:

- Eligible to claim a dollar for dollar credit on state income tax liability;
- Not allowed to designate a specific student or school as beneficiary;
- Limited by a first come, first served annual statewide cap of \$11 million.

Please visit [ExceptionalSC.org/donate](http://ExceptionalSC.org/donate) for more information and to make a donation. **Proviso 109.11** provides that South Carolina tax credits for donations to Exceptional SC may not exceed \$11 million for Fiscal Year 2018.

“Individuals ... who pay South Carolina taxes can make a donation to Exceptional SC and claim a dollar for dollar tax credit against their overall South Carolina income tax liability... *Donors can deduct contributions made to Exceptional SC on their federal income taxes under IRS Section 170.*”

Is this true?

# Charitable Tax Benefits

- The **federal** government (via §170) and **state** governments (via deductions and credits) provide tax benefits for charitable giving.
- This means that federally deductible gifts very commonly have (and have always had) the effect of reducing the donor's state or local tax liability.
  - Where charitable gifts and SALT are both deductible, any qualifying gift increases the donor's charitable contribution deduction but reduces her SALT deduction.
  - Where charitable gifts are deductible but SALT are not, allowing a full deduction for the gift enables the taxpayer to reduce their (nondeductible) state/local taxes by making a (deductible) gift.

# State Charitable Tax Credits

- Very common – 115 tax credits in 33 states
- Great variety – tax credits for donations to nonprofits, government agencies, government established funds
- 2 noteworthy clusters of existing tax credits:
  - Donations of conservation easements (typically hover in the 50-60% range)
  - Donations to “School Tuition Organizations” (several states offer 100% credits)



# States with Charitable Tax Credits

**Alabama**

California

**Georgia**

Illinois

**Kansas**

Maryland

**Missouri**

New York

Oklahoma

**South Carolina**

**Arizona**

Colorado

Hawaii

Indiana

Kentucky

Massachusetts

Montana

North Carolina

**Oregon**

Utah

West Virginia

Arkansas

Delaware

Idaho

Iowa

**Louisiana**

Michigan

Nebraska

North Dakota

Rhode Island

Virginia



# IRS CCA 201105010

**Office of Chief Counsel  
Internal Revenue Service  
memorandum**

Number: **201105010**

Release Date: 2/4/2011

CC:ITA:B01:JGMeeks  
POSTF-128223-10

Third Party Communication: None  
Date of Communication: Not Applicable

UILC: 170.12-07

date: October 27, 2010

to: Vicki L. Miller  
Associate Area Counsel (Kansas City, Area 9)  
(Small Business/Self-Employed)

from: Andrew Irving  
Senior Counsel, Branch 1  
(Income Tax & Accounting)

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subject: Transferable State Tax Credits

# Excerpts from CCA 201105010

- “The tax benefit of a **federal** or **state** charitable contribution **deduction** is not regarded as a return benefit that negates charitable intent, reducing or eliminating the deduction itself.” [cite to McLennan, Browning]
- “The issue raised by the current fact pattern is whether, in this respect, a tax benefit in the form of a state tax **credit**, or a transferable state tax credit, is distinguishable from the benefit of a state tax deduction.”
- “Based on our analysis of existing authorities, we conclude that the position reflected in McLennan, Browning, and similar case law generally applies. There may be unusual circumstances in which it would be appropriate to recharacterize a payment of cash or property that was, in form, a charitable contribution as, in substance, a satisfaction of tax liability. Generally, however, **a state or local tax benefit is treated for federal tax purposes as a reduction or potential reduction in tax liability**. As such, it is reflected in a reduced deduction for the payment of state or local tax under § 164, not as consideration that might constitute a quid pro quo, for purposes of § 170.”

# The Federal Reaction (so far...)

- **Mnuchin:** “I think it’s one of the more *ridiculous!* comments to think you can take a real estate tax that you are required to make and dress that up as a charitable contribution.”
- **IRS:** cautious, following developments
- **Internal Revenue Service Response:**
  - May 21, 2018: Notice of New Proposed Regs
  - August 24, 2018: Proposed Regs Released
  - October 11, 2018: deadline for comments
  - November 5, 2018: Public Hearing in D.C.

# Proposed §170 SALT Credit Regs

## August 23, 2018

- Treats *all* section 170(c) entities the same
  - New blue state charitable tax credits
  - Existing blue/red state charitable tax credits (including, most importantly, voucher tax credits)
- Taxpayer must reduce amount of federal charitable contribution deduction by the value of any state or local tax credit
  - Ignore state/local tax deductions (e.g., 13.3% in CA)
  - Ignore state/local tax credits of 15% or lower
  - Ignore federal tax deduction (e.g., top rate of 37%)

# Open Questions re: Prop. Regs

- Changes during Notice/Comment?
  - Guaranteed agitation for special carve-outs
- Opportunities with 15% safe harbor?
- Open Legal questions:
  - Deduction *and* Credit? (e.g., 15% + 13.3%)
  - Transferable tax credits?
  - Recipient's Basis in Credit?
  - Is use of credit a payment of tax? (regs suggest no, but pre-TCJA law allows a “purchaser” of tax credits to treat the use of the credit as a payment of tax)



# IRS/Mnuchin “Clarification”

September 5, 2018

- **IRS Press Release:**

*“Business taxpayers who make business-related payments to charities or governmental entities for which taxpayers receive state or local tax credits can generally deduct the payments as business expenses.”*

- **Mnuchin quote re: school voucher programs:**

*“The 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.”*

- **Open Question:** would a “business-related payment” be deductible under §162 even if it generates credit against otherwise nondeductible individual state/local taxes?

# Tax Savings as “Constructive Taxes”?

- Should IRS/Courts, in the absence of legislation, deem the tax savings derived from making charitable transfers to be “constructive taxes” (much like §1259 deems certain financial transactions to be “constructive sales”)?
- ***Not limited to Charitable Tax Credits...***
- ***All tax expenditures*** give taxpayers a means of satisfying their tax liability by making a qualifying outlay and thus could be recast as a “deemed payment” of a “constructive tax” that is potentially nondeductible.
  - e.g., home mortgage interest deduction
  - e.g., David Bradford’s “Weapons Supply Tax Credit”
- Requires specification of a baseline “true” level of tax liability – something other than the amount determined under state law (but see, e.g., 2017 IRS Advisory Notice: “*state or local law determines whether and when a property tax is assessed.*”)

# **“Social Contributions”**

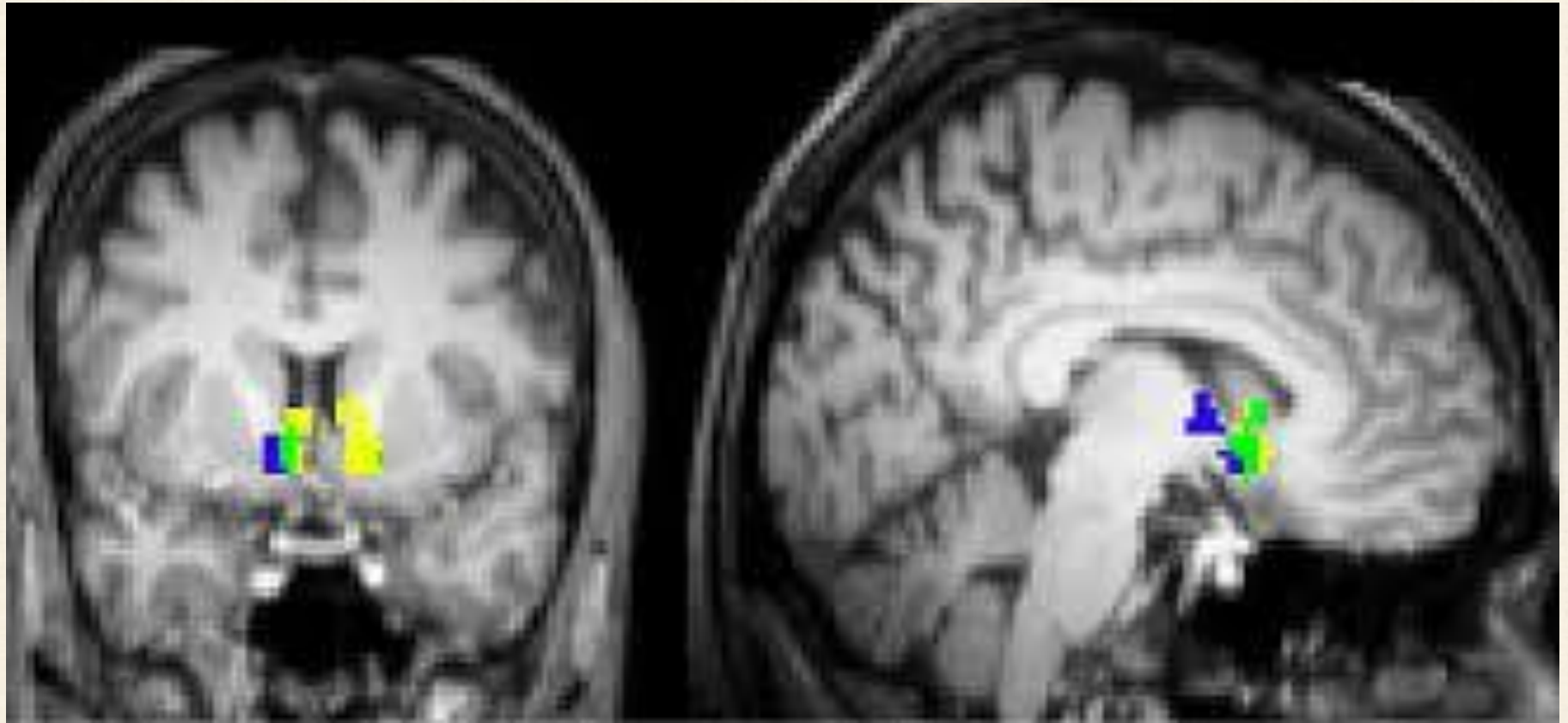
```
graph TD; A["Social Contributions"] --> B["State/Local Taxes"]; A --> C["Charitable Contributions"];
```

## **State/Local Taxes**

- Fund Education, Healthcare, Poverty Mitigation, Environmental Protection, Police and Fire
- “Mandatory”
  - Choice of Jurisdiction
  - Influence via Collective Choice
- Ventral Striatum Activated

## **Charitable Contributions**

- Fund Education, Healthcare, Poverty Mitigation, Environmental Protection, Religious Organizations, Opera
- “Voluntary”
  - Social Norms/Expectations
  - Used to Satisfy Mandatory Tax Liability
- Ventral Striatum Activated



## Ventral Striatum

*“Paying taxes to support a good cause activates the same evolutionarily ancient areas in the brain that respond to basic rewards like sweets, nutrients, or positive social contact. In other words, paying taxes can make people feel good.”*

***Question:***

**What Do Governments Do?**



***Question:***

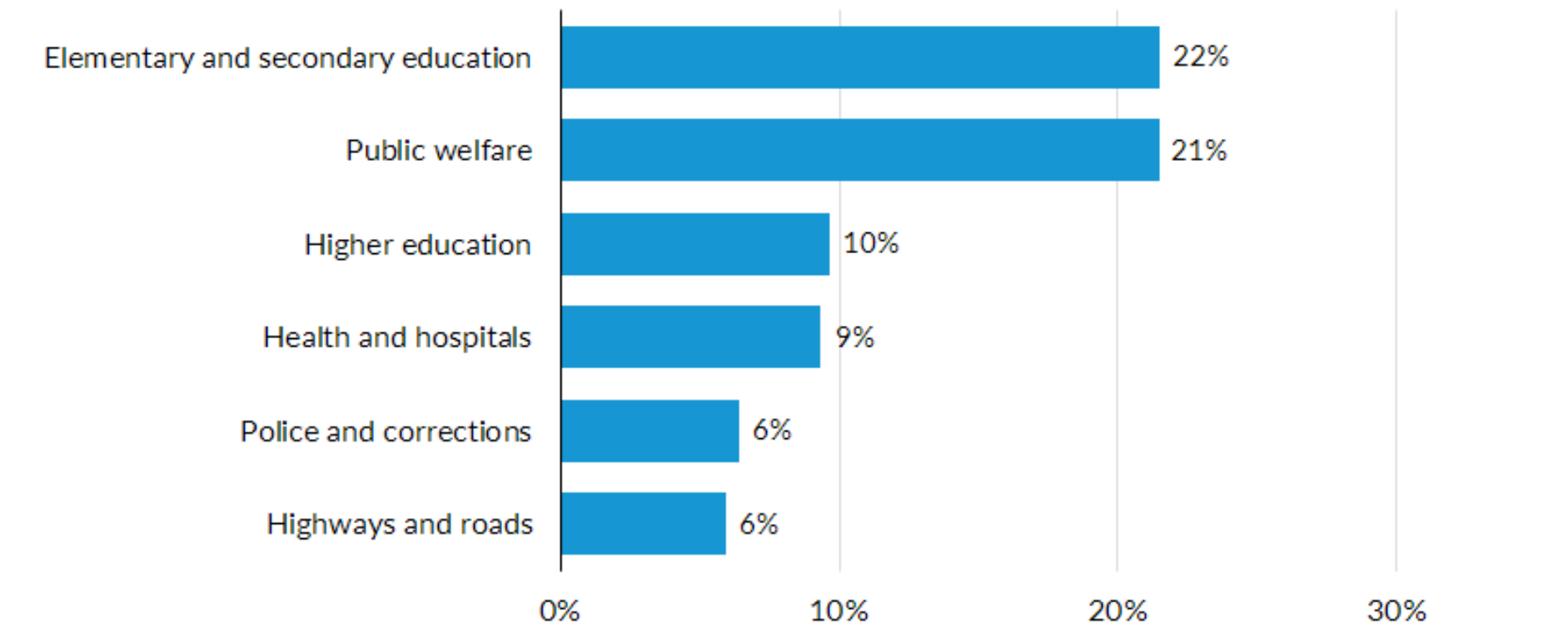
**What Do Governments Do?**

***Answer:***

**They Fund Charitable Activities**

# State and Local General Spending

By functional category, fiscal year 2015



Source: US Bureau of the Census, Survey of State and Local Government Finance, 2015.

Note: Excludes spending on government-run liquor stores, utilities, and insurance trusts. Medicaid spending is divided between the public welfare and health and hospitals functional categories, with the majority allocated to the former.

# The Cognate Nature of Taxes & Gifts

- “Taxation” in early societies consisted of forced labor and tributes paid (typically in kind) to king/emperor
- “Philanthropy” derives from this same history – contributions to ingratiate
- e.g., religious tithing – religion and government were mixed with little or no distinction
- Churchill:

# Discontinuity and Legal Instability

- Funding social spending via taxes is disfavored.
  - “Taxes” to pay for education: non-deductible
- Funding social spending via gifts is favored.
  - “Gifts” to pay for education: deductible
- Human response to discontinuous tax treatment → behavioral adjustments (e.g., creative tax planning, changes to institutional arrangements) to increase reliance on the favored form and reduce reliance on the disfavored form
- Often portends future change in legal rules

# The Power Not to Tax

- Taxation + appropriations is now disfavored, but Congress did not consider the implications.
- Governments fund public goods through means other than taxes:
  - tax expenditures: desired behavior X is rewarded by a reduction in state/local tax liability
  - regulation is now favored over taxation
  - borrowing via tax-exempt bonds (state tax exemption is now more valuable than pre-TCJA)