

SALT/Charitable Workaround Credits Require a Broad Fix, Not a Narrow One

Narrow Federal Action Would be Unfair, Arbitrary, and Ineffective

Institute on Taxation & Economic Policy

May 2018

Carl Davis

About The Institute on Taxation & Economic Policy

The Institute on Taxation and Economic Policy (ITEP) is a non-profit, non-partisan research organization that works on federal, state, and local tax policy issues. ITEP's mission is to ensure that elected officials, the media, and the general public have access to accurate, timely, and straightforward information that allows them to understand the effects of current and proposed tax policies. ITEP's work focuses particularly on issues of tax fairness and sustainability.

EXECUTIVE SUMMARY

The federal Tax Cuts and Jobs Act (TCJA) enacted last year temporarily capped deductions for state and local tax (SALT) payments at \$10,000 per year. The cap, which expires at the end of 2025, disproportionately impacts taxpayers in higher-income states and in states and localities more reliant on income or property taxes, as opposed to sales taxes. Increasingly, lawmakers in those states who feel their residents were unfairly targeted by the federal law are debating and enacting tax credits that can help some of their residents circumvent this cap—a policy this report will refer to as “workaround credits.” Specifically, states are offering sizeable tax credits in return for making so-called charitable gifts, rather than ordinary SALT payments, to support public services. This is advantageous to some taxpayers because charitable gifts are treated much more favorably than SALT payments under the new federal tax code.

For taxpayers, using these credits will result in a somewhat higher payment to their state governments (or in some cases, local governments) because the credits only offset part of the cost of donating. In New York, for instance, 85 percent of the donation is returned to the donor with tax credits. But for high-income taxpayers able to itemize at the federal level, the added benefits of the federal charitable deduction will often be large enough to both offset that higher state payment and return a net financial benefit to the taxpayer. Notably, most of the high-income taxpayers likely to benefit from these credits already received significant federal tax cuts under the TCJA.

One unusual result of this arrangement is that for state governments, the “tax cut” associated with the credits will produce an overall revenue gain because the donations expected to flow into state coffers will be larger than the credits flowing out (as noted above, every dollar received by New York’s government only triggers 85 cents of state tax credit payouts). More fundamentally, these credits shift state funding streams away from partly deductible tax payments and toward fully deductible payments that the federal government considers to be charitable gifts. The magnitude of this shift remains to be seen, however, as it will depend on how many taxpayers choose to take advantage of these credits.

Now that a critical mass of states has adopted these credits (including New York, New Jersey, Connecticut, and Oregon as of this writing), the focus of the debate will shift toward the federal level and whether the Internal Revenue Service (IRS), Treasury Department, and/or Congress will allow these workaround credits to proceed as state lawmakers have planned. This report makes the following findings about potential federal responses to these new workaround credits, and to state charitable tax credits more broadly:

- ◆ **During last year’s rushed debate over the TCJA, Congress was informed that states and localities were likely to respond to the SALT cap with these types of tax credit schemes, but it ultimately did nothing to prevent them.** Much of the debate around this topic has now shifted to whether the IRS has the authority to clean up the mess that Congress left behind, or whether legislation will be needed to address this issue.
- ◆ **Many observers have responded to these workaround credits with skepticism and shock, and understandably so.** The gifts being made under these schemes are not truly “charitable” according to any commonsense definition of that word, since the taxpayers are made financially better off by their gifts.
- ◆ **But fixing this problem will be more difficult than many observers have recognized, as it runs much deeper than these new workaround credits.** While these workaround credits have attracted significant attention in recent months, this type of abuse of the charitable giving deduction has been occurring for many years. Taxpayers have long claimed federal charitable deductions on so-called “charitable gifts” for which the taxpayer received a reimbursement from their state government via a tax credit.
- ◆ **The closest parallel to these workaround credits in existing tax law is a policy typically favored by conservatives: tax credits that steer funding to private K-12 school vouchers.** Tax accountants, private schools, and others in states with such credits have long marketed these programs as tools for exploiting the federal charitable deduction, and in the wake

of the new federal tax law they are now using language that mirrors that used by proponents of the new workaround credits. While blue-state efforts to circumvent the SALT cap have attracted more attention, financial advisors in deep-red Alabama and elsewhere are touting the ability of their existing charitable tax credits to help their residents “avoid losing” their SALT deductions. And the sales pitch has proven persuasive. Alabama’s entire allotment of private school tax credits was claimed more quickly this year than ever before.

- ◆ **Some observers have suggested that the IRS or Treasury Department could intervene with narrowly targeted guidance or a regulation affecting these new workaround credits, but not other pre-existing state charitable credits.** This approach would be highly problematic because the new workaround credits have much more in common with existing charitable tax credits than is commonly understood.
- ◆ **Narrow federal action would be unfair because it would treat similarly situated taxpayers differently depending on the types of causes to which they donate.** For example, narrow federal action would likely involve denying tax-credit-reimbursed deductions on donations to public schools, but not private schools, even if the impact of those two types of donations on taxpayers and state coffers was identical.
- ◆ **Narrow federal action would require making arbitrary distinctions between different types of organizations receiving donations.** Existing state charitable tax credits steer donations to a wide range of entities, including government agencies, public institutions, other levels of government, public-private partnerships, and private nonprofits providing services very similar to what a state government might otherwise provide. There is no way to draw a defensible line between the various types of organizations within this broad spectrum.
- ◆ **Narrow federal action would be ineffective because limiting the federal charitable deduction only for gifts to certain types of organizations would inevitably cause state and local leaders to become more creative in their tax credit designs, tweaking them so that they fall just outside of whatever restrictions the federal government might create.** For example, states could replace much of their direct aid to public universities or local governments with tax credit schemes that steer donations to those entities. Or if even those schemes were shut down (a policy change that would affect not just the new workaround credits, but many pre-existing credits as well), states could devise sophisticated programs routing donations through private nonprofits.
- ◆ **A better approach would address not just the new breed of workaround credits, but other state charitable tax credit schemes as well.** Rather than denying the federal charitable deduction for donations to some entities but not others, this approach would focus on the real economic impact of so-called “charitable gifts” from the perspective of the donor, and would reserve the deduction only for gifts that involve a genuine financial sacrifice. This approach would be simpler, fairer, and more effective.
- ◆ **While the IRS or Treasury Department may have the authority to take some action on this issue with new guidance or a regulation, Congress is far better suited to resolve this in a fair and administratively simple fashion.** There appears to be no basis in existing law for reducing the federal charitable deduction when some types of tax benefits are received (e.g., large state tax credits, including the new workaround credits) but not others (e.g., small state tax credits, state tax deductions, or even the federal deduction itself). This makes IRS or Treasury action an all-or-nothing proposition: either all types of tax benefits impact the size of the federal charitable deduction (an administratively complex outcome) or none of them do (that is, the problem remains unresolved). Congress, of course, faces no such limitations in rewriting the charitable deduction laws. It could either craft a more tailored law reducing the deduction when large state tax credits are received, or it could revisit its decision to cap the SALT deduction. If the SALT cap were replaced with a broader reform that did not preference charitable giving over SALT payments, the benefits of attempting to recast tax payments as charitable gifts would be eliminated entirely.