Caveat IRS: Problems With Abandoning the Full Deduction Rule

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In this report, the authors highlight the importance of the full deduction rule to sound tax administration. Further, they demonstrate that any effort to eliminate or limit its operation would have to overcome two sources of administrative complexity: computational difficulties in determining the appropriate amount of a donor's deduction and definitional challenges arising from allowing donors to claim a full deduction (undiminished by the value of any tax benefits) only for gifts to nongovernmental donees.

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I. Introduction

Several states are considering new tax credits that would reduce tax liability based on donations made by a taxpayer in support of various state programs.[1] In general, taxpayer contributions to qualifying organizations — including public charities and private foundations, as well as federal, state, local, and tribal governments — are eligible for the federal charitable contribution deduction under section 170.[2] In our previous article, we explained how current law supports the view that qualifying charitable contributions are deductible under section 170, even when the donor derives some federal or state tax benefit by making the donation.[3] We referred to this treatment as the "full deduction rule."

Some commentators have suggested that Treasury and the IRS could change existing law, whether through new regulations or by issuing a new interpretation of existing regulations, to limit the deductibility of taxpayer contributions when they trigger a state or local tax benefit to the donor.[4] Many legal and administrative concerns are associated with those actions. In this report, we argue that even if the IRS has the legal authority to implement the changes absent new legislation, it should decline to do so.

II. Background

Section 170 establishes that taxpayers may deduct charitable contributions made to qualifying organizations. Section 170(a) provides that the deduction is available for "any charitable contribution" made within the tax year. Also, 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."[5] While commonly overlooked in popular commentary on charitable giving, the provision allowing deductions for gifts to governments has been part of federal tax law for nearly 100 years.[6]

In general, when a donor receives some benefit, either directly or indirectly, from making an otherwise qualifying charitable contribution, the amount of their deduction under section 170 is reduced by the value of that benefit.[7] The principle at work here is one of substance over form. To the extent of the benefit received, the donor's contribution is treated as arising from non-charitable impulses and thus not deductible as a charitable gift. The treatment of the non-gift portion of those contributions depends on the nature of the benefit received, although when the donor receives goods or services the usual approach is to treat that portion of the transfer as a purchase. Importantly, this quid pro quo rule is not limited to situations in which the donor receives goods or services directly from the donee organization. A donor's receipt of indirect benefits, whether from a specific third party or otherwise, has the same effect on the amount deductible under section 170.[8] Consistent with the rule's mooring in substance over form, the emphasis is on whether the donor has received some benefit, not on the specific route that benefit took to find its way to the donor.

These rules have considerable intuitive appeal. Without them, taxpayers could easily convert nondeductible personal consumption into deductible charitable gifts. Nevertheless, as we detailed in our earlier article, 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, we have been unable to identify a single instance in the century-long history of the federal charitable contribution deduction in which a taxpayer was required to reduce the amount of her deduction by the value of tax benefits generated by making a gift. Instead, the law has emphasized that the tax consequences of charitable giving are to be disregarded in determining the amount of a charitable contribution deduction.[9] This rule has applied for all tax benefits — federal, state, and local — and regardless of whether the taxes reduced would have been deductible.

To illustrate the operation of these rules, suppose first that a taxpayer in the top federal tax bracket (facing a marginal tax rate of 37 percent) contributes $1,000 to a charitable organization like the United Way. Assuming the taxpayer itemizes her return, deducting this contribution yields a federal tax benefit of $370 to the taxpayer, making the net cost of the contribution for the taxpayer only $630. This is the full deduction rule in operation — that is, the taxpayer is entitled to a full deduction for the $1,000 gift, even though making the gift reduces her tax liability by $370. We suspect that few readers would find this treatment unusual or controversial. Nevertheless, it is worth noting that even in this commonplace example, the taxpayer has managed to eliminate $370 of ordinarily nondeductible federal income tax liability by making a deductible payment. She has, in effect, deducted $370 of her federal income taxes, despite the express nondeductibility of federal income taxes in the IRC.[10]

Next, suppose that the recipient of the taxpayer's $1,000 contribution is the federal government, rather than the United Way. As before, the taxpayer is entitled to a deduction of $1,000, which yields a tax benefit of $370, making the net cost of the contribution $630. The availability of a deduction for the full $1,000 contribution does not change simply because the donee organization is the source of the tax benefit resulting from the gift. Once again, there is nothing unusual or controversial in this treatment. It is simply a straightforward application of the law's equal treatment of direct and indirect benefits. Under the full deduction rule, the tax benefits of giving are ignored in determining the amount of the donor's deduction, regardless of whether the donee entity is the source of those tax benefits.

Put differently, what matters in determining the amount of the charitable contribution deduction is the nature of the benefit accruing to the donor, not the source of that benefit. If a donor makes a gift to either the United Way or the federal government and because of that gift receives, say, Super Bowl tickets from the NFL, the amount of the donor's charitable contribution deduction must be reduced by the value of the tickets, even though the donor receives them from the NFL rather than from the donee organization. For both tickets and taxes, direct and indirect benefits are treated the same: The receipt of Super Bowl tickets will reduce a donor's charitable contribution deduction, whether received from the donee organization or from the NFL itself. Likewise, tax benefits are ignored — and thus will not reduce a donor's charitable contribution deduction — regardless of whether the donee entity is the source of those benefits.

That the law makes no distinction between direct and indirect benefits will be obvious to anyone familiar with the law in this area. It is expressed most clearly in Rev. Rul. 67-246.[11] In that case, a local department store supported the annual fundraising drive of a charity by awarding a transistor radio (worth $15) to each person who contributed $50 or more to the charity. Donor B contributed $100 to the charity and received a transistor radio. Noting that "the fair market value of any consideration received for the payment *from any source* must be subtracted from the total payment," the IRS concluded that only $85 of B's payment qualified as a deductible charitable contribution. The logic at work here, which is supported by subsequent judicial authority, is that the *source* of the benefit received by the donor is irrelevant.[12] Thus, if there were any requirement to reduce the amount of a charitable contribution deduction by the value of resulting tax benefits (which there is not), that requirement would apply the same to all contributions, regardless of whether the gift was made to a governmental or nongovernmental entity.

Although current law allows taxpayers to deduct the full value of their charitable contributions despite the receipt of tax benefits, Treasury and the IRS could try to change that rule by issuing new guidance. It is difficult to predict what form this guidance might take, but it most likely would include a new requirement that taxpayers reduce the amount of otherwise qualifying charitable contribution deductions by some or all the tax benefits arising from the gift. Stated in this manner, the approach still leaves open many questions of scope and application. For example, would this new requirement extend to all charitable contributions, or only to a subset of qualifying gifts? And for those contributions covered, would the taxpayer be required to reduce the amount of the charitable contribution deduction by the value of all tax benefits — including federal, state, and local tax benefits — or only some subset of those tax benefits? Because of the multiplying complexities involved in requiring that all charitable gifts be reduced by all tax benefits, the IRS might adopt a more circumscribed approach requiring that any donor to a governmental entity must reduce the amount of her charitable contribution deduction by the value of some or all of any tax benefits granted by that governmental entity. However, allowing a full deduction for gifts outside this more circumscribed category despite the presence of tax benefits would represent a significant departure from current law's equal treatment of direct and indirect benefits. It would also be inconsistent with the statute. Section 170 confers equal treatment for gifts to qualified donee organizations without regard to their status as, or affiliation with, governmental entities. There is no favored "private" category in the law.

Independent of those legal points, any attempt to adopt a more circumscribed approach targeting only tax benefits derived by donors making gifts to government entities would require drawing fundamentally arbitrary — and even discriminatory — distinctions among substantively similar donees. Indeed, one obvious example of these arbitrary distinctions would be allowing a full deduction for gifts to private schools but disallowing a full deduction for gifts to public schools. In many cases it would also entail conferring more advantageous federal tax treatment for more generous state tax benefits (for example, 100 percent tax credits for gifts to private schools) than in the case of more modest tax benefits (for example, 75 percent tax credits for gifts to public schools). Because the statute makes no distinction between gifts to private schools and public schools, it is hard to imagine a legal basis upon which the IRS could assert that the distinction would be warranted. Also, any rule relying on such arbitrary distinctions would likely encourage parties to devise more complex arrangements involving some new mix of governmental and nonprofit entities to allow donors the benefit of the full deduction rule outside the circumscribed category. These considerations would, in turn, argue in favor of eliminating the full deduction rule for all gifts to all donees, although, again, that kind of approach would create considerable new administrative complexity for millions of taxpayers and donee organizations.

In the sections below, we consider two conceptually distinct sources of administrative complexity associated with abandoning the full deduction rule. The first concerns computational difficulties in determining the appropriate amount of the donor's deduction, while the second concerns definitional difficulties arising from any effort to allow donors to claim a full deduction (undiminished by the value of any tax benefits) only for gifts to nongovernmental donees. Any attempt to eliminate or limit the operation of the full deduction rule will have to overcome both sources of complexity.

III. Problems With Limiting Full Deduction Rule

A. Complexity in Computing the Deduction

As the examples above illustrate, 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 FMV of 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 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 on 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.

To illustrate, again consider a taxpayer with a marginal tax rate of 37 percent who makes a $1,000 gift — this time to Entity X, an organization that qualifies to receive deductible charitable contributions under section 170. Entity X could be a section 501(c)(3) organization like the United Way, the federal government, a state government, a university, a public or private elementary school, or any number of other qualifying organizations under section 170(c).[13] Assume that the IRS modifies or reinterprets its regulations to require donors to reduce the amount of their charitable contribution deductions to these donees by the amount of the tax benefit generated by the gift. For the moment, we will focus on the federal tax benefit inherent in the available deduction. In this example, if the taxpayer deducts the $1,000 contribution on her federal taxes, she receives a federal tax benefit of $370. Under the new rule, this $370 would be treated as a benefit to the donor, and the taxpayer would be required to reduce the amount she deducts to $630 ($1,000 minus $370). This is how the circularity begins: The taxpayer's federal tax benefit from the reduced deduction is now only $233 (0.37 multiplied by $630), so the taxpayer would be allowed to deduct $767 of her $1,000 contribution. But that is not the end of it under a regime that eliminates the full deduction rule. Additional calculations ensue with each change in the amount the taxpayer can deduct affecting the tax benefit from the contribution, and vice-versa, so that computing the taxpayer's allowable deduction is significantly more complicated without the full deduction rule.[14]

The headaches created by eliminating the full deduction rule would be even more acute for taxpayers seeking to deduct contributions for which a state or local tax benefit is available. State tax benefits for charitable contributions usually take the form of either a deduction or a credit. For a deduction, the same circularity problems described above apply, except here the computational difficulties are exacerbated because 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, if we abandon the full deduction rule, it becomes 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.

Even if we could determine the taxpayer's state marginal tax rate (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, assume again a taxpayer who makes a \$1,000 contribution to Entity X. Assume further that the taxpayer is subject to a 37 percent federal marginal tax rate and a 10 percent state marginal tax rate. This would imply a combined (federal and state) tax benefit of \$470. Because of the circularity problem referenced above, however, an algebraic formula would be needed to determine the appropriate deductible amount.[15] But of course 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. At first blush, it might seem easier to implement a rule 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 because of making a federally deductible gift. 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.[16] 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.[17] 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 whether 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 it would require knowing the value of state tax benefits 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, 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.[18] 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.

A potential rule that could avoid some of these computational difficulties would involve the IRS allowing taxpayers to deduct the full amount of their contributions (that is, preserve the full deduction rule), but also requiring them to include any tax benefits resulting from those contributions as income in the next taxable year. For example, the taxpayer in the 37 percent tax bracket who makes a qualifying contribution of $1,000 in 2018 would receive a $1,000 deduction in tax year 2018 and recognize $370 of additional income in tax year 2019 (that is, the economic value of the deduction the taxpayer receives under current law). Although this approach to eliminating the full deduction rule would avoid some computational circularities described above, it would involve significant new administrative burdens for taxpayers and the IRS. For state tax benefits, this approach would require expanding IRS knowledge of state tax return information. For example, calculating the state tax benefit associated with a contribution would require knowing the value of the state credit (or the taxpayer's marginal tax rate(s), if a deduction) as well as state tax liability absent the benefit (assuming the state benefit is nonrefundable). An additional stumbling block with this approach would be doctrinal because it is well established that programs that reduce one's tax liability generally do not constitute taxable income.[19]

B. Definitional Complexity and Line Drawing

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. By contrast, abandoning the full deduction rule would require substantial computational complexity of the sort described above.

Given the many computational difficulties involved in abandoning the full deduction rule, the IRS may seek to devise a rule of more limited scope — perhaps, for example, requiring only that a donor to a governmental entity must reduce the amount of her charitable contribution deduction by the value of some or all of any tax benefits granted by that governmental entity. In our view, it is difficult to reconcile that interpretation with the text of the statute. Specifically, that approach would mean contributions to governmental entities were deductible to a lesser extent than contributions to nongovernmental entities, even though the statute itself creates no such distinction.

To illustrate, again consider a taxpayer who donates $1,000 to the federal government, and who claims the charitable contribution deduction for this amount on her tax return. Under the more circumscribed rule suggested immediately above, this donor could not claim a deduction for the full $1,000, but rather could only deduct a more limited amount to reflect the value to her of the federal deduction. This result is contrary to the law's equal treatment of direct and indirect benefits, as discussed above. After all, a donor of $1,000 to the United Way receives the exact same tax benefit as a donor to the federal government. Treating the indirect benefit more favorably than the direct benefit would suggest that the bad result can be avoided by giving the benefit a more circuitous route, which of course is contrary to case law requiring that direct and indirect benefits be treated the same.

Perhaps more importantly, any effort to apply different rules for gifts to governmental donees is contrary to the clear meaning of the statute, which generally allows taxpayers to deduct the full amount of their charitable contributions,[20] including contributions made to the federal government.[21] To be sure, cash or property transferred from a taxpayer to a qualifying organization does not always constitute a charitable contribution in the meaning of the statute, like when the organization provides goods or services to the taxpayer in exchange for the contribution. This is, after all, the rationale behind the existing quid pro quo regulation. But unlike more common quid pro quo situations (for example, the tote bag received in exchange for a gift to a public radio station), treating tax incentives granted by a donee government as a quid pro quo would require concluding that contributions to the federal government could never be fully deducted by taxpayers. And because the statute clearly specifies that those contributions are deductible, an interpretation of the statute that is inconsistent with this rule must not be correct.

Additional problems would arise in determining when a gift has been made to a "governmental entity" that would therefore reduce the amount of a taxpayer's charitable contribution deduction by the value of tax benefits provided by that entity. In the context of the federal government, this issue might arise for gifts made to hospitals operated by the Department of Veterans Affairs. VA hospitals are plainly within the scope of donees entitled to receive deductible donations under section 170(c). The hospitals themselves do not grant tax deductions, but these hospitals are plainly part of the federal government, and federal law grants a tax benefit for donations to these hospitals. Thus, if the IRS adopts a rule limiting the deductibility of gifts to governmental entities, the rule will bring within its scope gifts to VA hospitals. At the same time, it is difficult to see why a gift to a VA hospital should be treated less favorably than a gift to a private hospital.

Similar issues arise for gifts to state or local governmental entities. If a donor to a governmental entity must reduce the amount of her charitable contribution deduction by the value of any tax benefits granted by that entity, it will be necessary to determine which donee organizations constitute "governmental entities" and which do not. Although the question might appear simple, developing rules to guide taxpayer activity in this area would require the IRS to wade into a messy and fact-intensive set of questions.

A useful illustration of the complexities involved includes the Exceptional SC Fund — the section 501(c)(3) entity authorized by South Carolina law to receive donations to help fund private school tuition scholarships for children with special needs. This fund was established by the South Carolina legislature and is governed by a board of directors consisting entirely of persons appointed by the Governor and the two chairpersons of the House Ways and Means and Senate Finance committees. Also, disbursements by the fund are governed by a detailed state law specifying the terms and conditions for the use of the resources. Donations to the fund entitle the donor to a 100 percent state income tax credit. Given the state government's role in establishing, funding, and operating the fund, it would seem to fit within the scope of any new rule limiting the application of the full deduction rule for gifts to governmental entities. At the same time, however, the fund's status as a section 501(c)(3) organization might lead unsuspecting donors to conclude that the fund is not a governmental entity subject to the new rule and thus that contributions to the fund are fully tax deductible under the federal income tax.

Another issue involves the source of the tax credit for donating to the fund. The Exceptional SC Fund itself does not grant tax credits — rather, the fund is authorized to receive donations (which must be devoted to purposes enumerated in the state statute), and it is the state government that grants the tax credit. Would it matter that it is not the fund itself, but rather its creator, that grants the tax credits for gifts to the fund?

Nearly identical issues arise for many other types of gifts that might be implicated by a rule limiting the deductibility of gifts to governmental entities. For example, would a donor making a gift to a local public elementary school be required to reduce the amount of her federal charitable contribution deduction by the value of any state tax benefits arising from the gift? Here, as with the Exceptional SC Fund, the donee organization is not the originator of the tax benefits accruing to the donor. The local public elementary school would likely be regarded as a "political subdivision" of the state (or at least the district of which the school is a part would be regarded as such), though presumably the school or the district or the state could establish a special fund to provide financial assistance to the school. It is hard to see any principled basis for distinguishing among the many permutations that parties might devise to facilitate the flow of resources from individuals to educational organizations.

What about contributions to a public-private partnership between a state or local government and a charitable organization? The question is sure to arise because many charitable organizations are at least partially funded by state or local governments. In fact, as we detailed in our previous article, many state tax credits exist to encourage taxpayers to contribute to specific public and semi-public charitable organizations.[22] Moreover, the IRS has long recognized "lessening the burdens of government" as one of the justifying rationales for extending tax-exempt status to a section 501(c)(3) organization.[23] That an entity can substantiate its charitable purpose by reference to its role in lessening the burdens of government reveals the lack of a sharp distinction between "governmental" and "nongovernmental" tax-exempt entities. Governments and other nonprofits are largely engaged in the same activities, including education, public welfare, healthcare, and environmental protection. Any attempt to limit the operation of the full deduction rule only for gifts to "governmental" entities would likely encourage parties to exploit (and enlarge) the already substantial overlap between and among the various types of nonprofit entities.

Some commentators have suggested drawing a distinction between, on the one hand, a contribution to provide for "essential government functions,"[24] for which a charitable deduction would be denied, and on the other hand, a contribution to provide for some other charitable function, which would remain deductible. Such a distinction, like other ad hoc distinctions that we have considered, would be problematic. In constitutional law, the Supreme Court long ago found the "traditional government function" test to be unworkable.[25] Meanwhile, in tax law, the essential government function test continues to apply, albeit in narrow and congressionally specified circumstances that are inapposite to section 170.

Consider the following two contexts in which the concept of an essential government function is used in tax law. Evaluating essential government functions helps determine whether a bond will be considered a tax-exempt bond or a private activity bond.[26] It's beneficial for the financed project to accomplish an essential government function because, at least for purposes of this narrow exception, such a bond would be tax exempt. Moreover, Native American tribes can issue tax-exempt bonds for only an essential government function,[27] limiting tribal, but not state and local, borrowing. Again, it's considered beneficial to serve an essential government function, and the statutory definition is fairly broad.[28]

Adopting the essential government function test for deductible charitable contributions, however, is problematic for at least three reasons. First, as the above examples illustrate, Congress is more than capable of adopting the test in circumstances it deems appropriate. Indeed, regarding Native American tribes, the same section of the IRC that treats tribes less favorably than states vis-à-vis the tax exemption makes it equally clear that tribes are to be treated as states for purposes of section 170.[29] Thus, there is a strong plain language case against transposing the essential government function test (or an analogue) into the realm of charitable contributions.

Second, transposing the essential government function test onto charitable contributions would create the same kind of unintended and harmful results that we have emphasized throughout this report. For tax-exempt bonds, Congress has expressed its intent to provide a tax subsidy for projects that perform essential government functions. But for charitable contributions, importing the test would deny the conceptually similar subsidy provided by section 170 to essential government functions. Thus, importing the test would mean that a public school could be financed by tax-exempt bonds, but contributions to pay for programs in that school would not be deductible under section 170. That result would be anomalous and at odds with existing legislative intent to support essential government functions, including through section 170.

Finally, imposing the essential government function test on the deductibility of charitable contributions would create additional unintended consequences. There are numerous hypothetical examples, but consider just one. Suppose the essential government function test was imported into section 170, and a donor wanted to make a contribution to fund a sports complex at a local high school. Further, suppose that the IRS or a court decided that such a facility doesn't constitute an essential government function and on those grounds permitted the donor to deduct the contribution for federal tax purposes. Would that finding mean that a Native American tribe could not use tax-exempt bonds to build a sports complex at a local high school because the complex doesn't constitute an essential government function?

IV. Conclusion

We understand that the proposed state contribution-credit programs we have been discussing, 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 (P.L. 115-97). 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 in 2017 millions of taxpayers subject to the AMT 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. In our previous article,[30] we demonstrated why these programs were, and remain, grounded in long-standing tax law, respected by the IRS and the courts. In this article, we have demonstrated in greater depth why the full deduction rule is a sound rule of tax administration. Thus, to the extent the IRS reacts to these programs by restricting the full deduction rule, it would be treading on uncertain legal and practical grounds.

FOOTNOTES

[1] As of this writing, proposed legislation has been introduced in California, Connecticut, the District of Columbia, Illinois, Indiana, Maryland, Nebraska, New Jersey, New York, Oregon, Virginia, and Washington.

[2] Section 170(a).

[3] Joseph Bankman et al., "State Responses to Federal Tax Reform: Understanding the Emerging Battle Over State Charitable Tax Credits," *Tax Notes*, Apr. 30, 2018, p. 641.

[4] *See*, *e.g.*, Andy Grewal, "Can States Game the Republican Tax Bill With the Charitable Contribution Strategy?" *Yale J. Reg.* (Jan. 3, 2018); Eric Rasmussen, "Getting Around the State and Local Tax Deduction Limit," SSRN (Jan. 9, 2018); and Jared Walczak, "Strategies to Preserve SALT Deductions for High-Income Taxpayers: Will They Work?"**(Jan. 5, 2018); and David Gamage, "Charitable Contributions in Lieu of SALT Deductions,"** *State Tax Notes*, Mar. 12, 2018, p. 973.

[5] Section 170(c)(1).

[6] Revenue Act of 1921, section 214(a)(11), 42 Stat. 227 (1921). Contributions to governmental entities were included in estate tax charitable deductions beginning with the Revenue Act of 1918. Revenue Act of 1918, section 403(a)(3), 40 Stat. 300 (1918).

[7] Reg. section 1.170A-1(h)(2)(i).

[8] *See*, *e.g.*, *Singer Co. v. United States*, 449 F.2d 413, 422-423 (Ct. Cl. 1971); *Ottawa Silica v. United States*, 699 F.2d 1124 (Fed. Cir. 1983); Rev. Rul. 67-246, 1967-2 C.B. 104.

[9] *See*, *e.g.*, *Skripak v. Commissioner*, 84 T.C. 285 (1985) (finding "a taxpayer's desire to avoid or eliminate taxes by contributing cash or property to charities cannot be used as a basis for disallowing the deduction for that charitable contribution").

[10] Section 275(a)(1).

[11] *See* Example 11.

[12] *See also Singer*, 449 F.2d at 422-423 ("Plaintiff would have us decide the case by distinguishing between a direct or indirect benefit derived. In other words, plaintiff would say that if the transferor received, or expected to receive, benefits from a transfer to a charitable transferee, which benefits were to be received only indirectly, then regardless of the magnitude of those benefits, the transfer would still qualify as a charitable contribution deduction under section 170. However, if those same benefits were received, or expected to be received, directly from the transferee, plaintiff would concede that, given a substantial quid pro quo, the transfer would not come within the definition of a 'gift' or 'contribution' for purposes of deductibility under section 170. Obviously, we cannot agree with plaintiff's distinction.").

[13] We begin with this intentionally ambiguous donee entity (Entity X) to emphasize that the tax benefits of potential concern to the IRS arise in all these settings. Donations to any of these entities entitle the donor to a federal charitable contribution deduction, even though this deduction reduces the donor's nondeductible federal income tax liability. Likewise, state governments commonly provide tax deductions or credits for donations to many of these entities, and those state tax benefits may have the effect of reducing the donor's nondeductible state or local tax liability.

[14] In some cases, the taxpayer's allowable tax deduction for the contribution could be calculated using an algebraic formula like c/(1 + t), where c is the amount of the contribution and t is the taxpayer's effective marginal tax rate. This formula does not hold, however, for taxpayers whose income is close to a threshold at which a different marginal tax rate applies. It is also difficult to implement this formula when the taxpayer's effective marginal tax rate differs from the statutory tax rate, as is often the case because of various phaseouts.

[15] For example, c/(1 + tfs), where c is the amount of the contribution and tfs is the combined federal and state marginal tax rate.

[16] A state may make its credit percentage a function of the taxpayer's taxable income, which would result in the same circularity problems discussed above. We can generalize this statement by noting that any time the value of a state tax benefit is a function of the taxpayer's federal taxable income, it will not be possible to determine the proper amount of their federal

charitable contribution deduction under any federal rule that seeks to reduce the amount of that deduction by the value of the state tax benefit.

[17] For a partial inventory of charitable tax credits available under state individual income tax statutes, see Bankman et al., *supra* note 3.

[18] *Tempel v. Commissioner*, 136 T.C. 341, 353 (2011).

[19] *See Randall v. Loftsgaarden*, 478 U.S. 647, 657 (1986) ("the 'receipt' of tax deductions or credits is not itself a taxable event, for the investor has received no money or other 'income' within the meaning of the Internal Revenue Code"); and IRS, "Coordinated Issue Program Appeals Settlement Guidelines: State and Local Location Tax Incentives (I.R.C. Sec. 118 SALT) " (Mar. 2, 2011) (reflecting the IRS position that a "SALT or [a] similar tax incentive . . . is not income under I.R.C. section 61").

[20] *See* section 170(a).

[21] *See* section 170(c)(1).

[22] *See* Bankman et al., *supra* note 3.

[23] Reg. section 1.501(c)(3)-1(d)(2); Rev. Rul. 85-1, 1985 C.B. 177; and Rev. Rul. 85-2, 1985 C.B. 178.

[24] *See* Peter Faber, "Do Charitable Contributions Avoid the TCJA SALT Deduction Limit?" *State Tax Notes*, Apr. 23, 2018, p. 309.

[25] *See Garcia v. San Antonio Transit Authority*, 469 U.S. 528 (1985).

[26] Section 141(c)(2)(A).

[27] Section 7871(c)(1).

[28] Section 7871(e).

[29] Section 7871(a)(1)(A).

[30] *See* Bankman et al., *supra* note 3.

END FOOTNOTES