

Charitable Contributions Which Reduce State Taxes

The Tax Cuts and Jobs Act (TCJA) imposed a new limit on the deduction for State and Local Taxes (SALT) to a maximum of \$10,000 per year. This is similar to other changes we've had over the years such as putting percentages bases on items (medical, 2% itemized deductions, etc.) and dollar limits on other items such as the amount of debt eligible for the home mortgage interest (maximum of \$1,000,000 – now \$750,000). This SALT limit theoretically affects taxpayers in high income tax or real estate tax states. The media has picked California, New Jersey, and New York as particular examples of where these taxpayers live but it can affect anyone.

According to one report this \$10,000 SALT limitation appears to actually affect only about 5% of the taxpayers in the country. Many taxpayers who could have been affected but aren't affected include those who will be using the higher standard deduction instead of itemizing and those subject to AMT (taxes are an addback). But for those that are affected by this limitation, it can result in an increase in their federal income taxes.

Some states have created or proposed creating a program that gives a state or real estate tax credit when the taxpayer makes a charitable contribution to a particular charity.

In the past IRS has generally ignored these types of programs because the net tax result of a charitable contribution was substantially the same as a SALT deduction unless the taxpayer was subject to AMT. Now with the \$10,000 SALT limitation, IRS has taken a second look at these programs feeling the prior "ignoring" would undermine Congressional intent created by the SALT limitation. In Notice 2018-54 (issued June 11, 2018) IRS announced it would be issuing proposed regulations addressing these programs. The regulations have now been issued.

Proposed Regulations issued August 27, 2018, address situations where taxpayers make charitable contributions which reduce state taxes. These regulations apply to new SALT credit programs as well as ones existing before the TCJA. Here is a short summary of these regulations;

1) State Tax Credit received - Under these regulations if a taxpayer makes a payment or transfers property to or for the use of a charitable organization (as found in Section 170(c)) AND the taxpayers receives a state tax credit in return, the tax credit is considered a return benefit and the taxpayer must reduce the charitable contribution deduction.

Example – Taxpayer makes a contribution to Charity A of \$1,000 and receives a state tax credit of \$700, the taxpayer must reduce the charitable contribution by the \$700 and can only deduct the remaining \$300. The \$700 of benefit received

is considered to be state taxes paid and is deductible accordingly along with all limitations, AMT add backs, etc.

The regulations provide a de minimis exception that briefly states a reduction of the charitable contribution is not required if the benefit received is equal to 15% or less of the applicable charitable contribution.

Example – Taxpayer makes a contribution to Charity A of \$1,000 and receives a state tax credit of \$125, the taxpayer is not required to reduce the charitable contribution by the \$125 and can deduct the entire \$1,000 as a charitable contribution.

2) State tax deduction – Under these regulations IRS stated it felt a state tax deduction was not as beneficial to a taxpayer as a state tax credit. It also stated the benefits of a state tax deduction depended on the taxpayer's tax rates applicable to Federal and the state. Further the calculations required to determine this benefit would be complex and add to administrative and taxpayer burden. Therefore IRS stated a reduction of the charitable contribution is generally NOT required in the case of the receipt of a state tax deduction.

Example – Taxpayer makes a contribution to Charity A of \$1,000 and receives a state tax deduction of \$1,000, the taxpayer is not required to reduce the charitable contribution by the \$1,000 and can deduct the entire \$1,000 as a charitable contribution.

Exception – If the taxpayer receives or expects to receive a SALT deduction that exceeds the amount of the taxpayer's payment or the FMV of the property transferred, the taxpayer's charitable contribution deduction must be reduced.

IRS asked for suggestions regarding a rule that could be applied if a taxpayer would decline to accept the state or local tax credits. Watch for changes to these regulations either as proposed or final.

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