COMMENTS OF THE ATTORNEYS GENERAL OF NEW JERSEY, CALIFORNIA, CONNECTICUT, AND NEW YORK

October 11, 2018

By electronic submission to www.regulations.gov

Mr. Charles P. Rettig
Commissioner of the Internal Revenue Service
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

Re: IRS REG-112176-18
Proposed Rulemaking re: Contributions in Exchange for State or Local Tax Credits
83 Fed. Reg. 43563 (Aug. 27, 2018)

Dear Commissioner Rettig:

We, the undersigned Attorneys General of New Jersey, California, Connecticut, and New York oppose the IRS's plans to undermine state and local programs that promote charitable donations through the use of tax credits.

To encourage charitable giving and provide relief to taxpayers, the majority of states have developed programs that offer state and local tax ("SALT") credits to individuals who make charitable contributions to qualifying institutions. More than 100 of these programs exist in 33 states, incentivizing individuals to donate to causes ranging from natural resource preservation and domestic violence shelters to financial aid for higher education.[1] Until recently, the IRS has treated contributions made pursuant to these programs as deductible under Section 170 of the Internal Revenue Code. *See* Internal Revenue Service Chief Counsel Advisory 201105010 (Feb. 4, 2011) ("IRS CCA 201105010"). This summer, however, the IRS announced plans to reverse course in a Notice of Proposed Rulemaking ("NPRM"). *See* Notice of Proposed Rulemaking and Notification of Public Hearing, 83 Fed. Reg. 43563 (Aug. 27, 2018). The IRS's proposal would now require taxpayers to subtract the value of any SALT credits they receive from their charitable contribution deductions—a requirement without precedent in the 101-year history of the charitable deduction. The IRS's proposal is arbitrary and capricious and contrary to law, and it undermines basic federalism principles and sound public policy.

The proposed regulations are arbitrary and capricious for three independently sufficient reasons. First, it is black letter law that the IRS must give equal treatment for tax credits and tax deductions, as both have the same effect of reducing the beneficiary's tax liability. Yet the IRS's proposal would disregard that basic principle by treating tax credits—but not tax deductions—as

[1] Joseph Bankman, David Gamage, Jacob Goldin, Daniel Hemel, Darien Shanske, Kirk J. Stark, Dennis J. Ventry Jr., and Manoj Viswanathan, *State Responses to Federal Tax Reform: Charitable Tax Credits,* 159 TAX NOTES 641, 641-42, 655 (2018).

evidence of a *quid pro quo* that reduces the amount of a charitable deduction. And in so doing, the IRS would privilege tax benefits granted by the federal government over those granted by the states. Second, the IRS's proposal would prejudice states and localities relative to foreign governments. Indeed, while a taxpayer would be required to subtract the value of SALT credits from a charitable deduction, the receipt of a foreign tax benefit would leave the same charitable deduction unchanged. Third, the IRS's proposal—together with the "clarification" for business taxpayers it issued on September 5—would favor corporations over people, because corporations could still deduct charitable contributions that trigger SALT credits while individuals could not. Had Congress wanted to create these arbitrary distinctions, it would have done so by statute. But Congress did not, and the IRS is not free to engage in lawmaking in its place. Because Section 170 offers no support for the IRS's new distinctions between tax credits and deductions, between different governmental entities, and between corporations and individuals, the IRS's proposal is arbitrary and capricious and contrary to law.

The IRS's proposal is equally misguided as a matter of policy. The proposed rules would undermine state sovereignty by depriving state and local governments of the revenue necessary to sustain vital public services. In addition, the proposed regulations would upset the status quo for the individuals, charities, and governments that have come to depend on existing programs. And to make matters worse, these proposed rules are not administrable in practice.

The IRS should withdraw its proposal—as both the law and common sense demand. The IRS should not play politics; it should instead confirm its longstanding interpretation of federal law.

I. THE PROPOSED REGULATIONS ARE ARBITRARY AND CAPRICIOUS AND CONTRARY TO LAW.

The IRS's proposed rules violate basic tax law principles, discriminate against state and local governments, and favor corporations over individuals. But Congress has never endorsed any of these arbitrary distinctions in Section 170, and the IRS may not engage in this lawmaking unmoored from the statutory text. The IRS must withdraw its proposal and reinstate its prior and consistent interpretation of the Tax Code.

a. <u>The Proposed Rules Would Violate Basic Tax Law Principles By Treating Tax Credits Differently From Tax Deductions.</u>

By creating distinct tax regimes for credits and deductions, the proposed regulations elevate form over substance. While the proposed regulations regard the receipt of tax credits as evidence of a *quid pro quo*, requiring taxpayers to subtract the value of SALT credits from their charitable deductions, they discount the value of tax deductions. Such divergent treatment of substantially similar tax incentives contravenes the bedrock tax principle of "substance over form." *See True v. United States*, 190 F.3d 1165, 1174 (10th Cir. 1999).

Section 170 of the Code permits taxpayers to deduct from their taxable income "any charitable contribution . . . made within the taxable year." I.R.C. § 170(a). It defines "charitable contribution" as a "contribution or gift to or for the use of" qualifying governmental or charitable institutions. I.R.C. § 170(c). To claim a charitable contribution deduction under Section 170, a taxpayer must have acted with "charitable intent." *Scheidelman v. Commissioner*, 682 F.3d 189, 199 (2d Cir. 2012). "The *sine qua non* of a charitable contribution," wrote the Supreme Court in *United States v. American Bar Endowment*, "is a transfer of money or property without adequate consideration." 477 U.S. 105, 118 (1986). If a taxpayer does receive consideration, the taxpayer may still deduct "[t]he amount of any cash paid and the fair market value of any property . . . transferred by the taxpayer to [a qualifying] organization . . . over . . . [t]he fair market value of the goods or services the organization provides in return." Treas. Reg. § 1.170A-1(h)(2).

Critically, case law and the IRS's own administrative guidance have uniformly held that the expectation of a tax benefit does *not* give rise to a *quid pro quo* that would negate charitable intent or reduce the amount of a charitable deduction. *See, e.g.*, *Browning v. Comm'r.*, 109 T.C. 303, 325 (1997) (rejecting as "untenable" the argument that a taxpayer "may be entitled to a charitable contribution deduction of some lesser amount on account of the economic value of the deduction"); *McLennan v. United States*, 24 Cl. Ct. 102, 106 n.8 (1991) (noting that "a donation . . . for the exclusive purpose of receiving a tax deduction does not vitiate the charitable nature of the contribution"), *aff'd* 994 F.2d 839 (Fed. Cir. 1993); *Transamerica Corp. v. United States*, 15 Cl. Ct. 420, 465 (1988) (stating that "[e]ven where the donation is made solely for the purpose of obtaining a tax benefit, the taxpayer is entitled to the deduction"); *Skripak v. Comm'r.*, 84 T.C. 285, 319 (1985) (averring that "a taxpayer's desire to avoid or eliminate taxes . . . cannot be used as a basis for disallowing the deduction for that charitable contribution"). Simply put, existing authority uniformly suggests that tax benefits do not constitute either "consideration," *see Am. Bar Endowment*, 477 U.S. at 118, or a "good[] or service[]" that gives rise to a *quid pro quo*, *see* Treas. Reg. § 1.170A-1(h)(2). Rather, courts and the IRS have treated tax benefits as a simple reduction in tax liability, not as consideration reflecting a bargained-for exchange.

In a memorandum released on February 4, 2011, the IRS's Office of Chief Counsel addressed the deductibility of charitable contributions that trigger SALT credits. *See* IRS CCA 201105010. Drawing on the precedents cited above, and noting that "[t]he 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," the Chief Counsel expressly approved of charitable tax credit programs, advising taxpayers that they could still deduct the full amount of their charitable donations without subtracting the value of SALT credits. *Id.* at 2-5. In so doing, the Chief Counsel squarely confronted the question of whether "a tax benefit in the form of a state tax credit . . . is distinguishable from the benefit of a state tax deduction." *Id.* at 4. The Chief Counsel's answer was clear. "[W]e see no reason," the Chief Counsel concluded, "to distinguish the value of a state tax deduction, and the value of a state tax credit, or to draw a bright-line distinction based on the amount of the tax benefit in question." *Id.* at 5.

The Chief Counsel correctly rejected this formalistic distinction. Indeed, the effect of a tax credit is the same as that of a tax deduction—both reduce the beneficiary's tax liability and incentivize particular kinds of behavior. As the Chief Counsel recognized, therefore, a rule treating credits as evidence of a *quid pro quo* while discounting the value of deductions would be incongruous. Significantly, the Tax Court subsequently agreed with the Chief Counsel. In *Tempel v. Commissioner*, the court observed that "[s]ome commentators have suggested a State's grant of State income tax credits to taxpayers who make charitable donations . . . should be treated as a transaction that is in part a sale and in part a gift." 136 T.C. 341, 351 n.17 (2011). Citing IRS CCA 201105010, and noting that "[t]he Commissioner has eschewed this approach," the court "discern[ed] no reason to disturb this practice." *Ibid.* "A reduced tax," the court went on, should not diminish the amount of a charitable deduction. *Ibid.*

With the proposed rules, however, the IRS has abandoned this longstanding approach by creating one regime for tax credits and another for tax deductions. *See Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944) (identifying "consistency with earlier . . . pronouncements" as a factor in evaluating agency action). In so doing, the IRS has elevated form over substance and engaged in arbitrary and capricious rulemaking. The difference between a tax deduction and a tax credit is typically a difference of degree of economic benefit; it is not a different *kind* of benefit. But the IRS has now chosen to ignore the tax benefits flowing to a taxpayer from deductions, while accounting for the tax benefits that result from credits. This is a creature of the IRS's own imagination, and not an interpretation of anything found in Section 170 of the Tax Code.

The IRS implicitly acknowledges the false dichotomy between tax credits and deductions when it tries to address that inconsistency by adopting a *de minimis* exception for contributions yielding credits that do not exceed 15 percent of the donation. Prop. Treas. Reg. § 1.170A-1, 83 Fed. Reg. 43563, 43565, 43571 (Aug. 27, 2018). According to the IRS, a credit worth 15 percent of a charitable contribution approximates the maximum value of a corresponding state and local deduction. *Ibid.* The *de minimis* exception, as such, is meant to equalize the treatment of credits and deductions. *Ibid.* But that attempt, even if successful, would not justify a policy decision to ignore entirely what the IRS's logic now concludes, for the first time, are *quid pro quo* benefits arising from tax deductions, and to address only the *quid pro quo* benefits arising from tax credits. It certainly does not justify creating an arbitrary and irrational divide between different tax incentives based on form rather than economic substance.

Moreover, the IRS's efforts to shore up its approach fall short in another respect. The NPRM does not address the value of federal charitable deductions, even though such deductions are often worth far more than 15 percent of a contribution. For taxpayers in the top marginal tax bracket, a federal deduction yields a tax benefit worth 37 percent of the donation. It is contrary to "substance over form" principles to allow a full deduction in the case of a tax benefit worth 37 cents on a dollar, while permitting only a partial deduction for a tax benefit worth 16 cents on a dollar. Yet that is exactly what this NPRM does. And the tax benefits from the federal deduction have been even more striking in the past. In 1977 the top marginal tax rate was 70 percent, and in 1960 it was 91 percent. Despite a huge number of federal tax overhauls, and the sometimes enormous tax benefits received, federal tax law has never considered tax benefits received as a consequence of a charitable gift to be a *quid pro quo*.

Indeed, the IRS's *de minimis* exception introduces additional inequities by creating an illogical and economically unsound "cliff effect." Under the *de minimis* exception, a taxpayer who makes a contribution that triggers a SALT credit not exceeding 15 percent of the donation will receive a full charitable deduction, while a taxpayer who makes a donation that yields a credit worth 16 percent of the contribution will be required to subtract the *entire* value of the credit from the charitable deduction. Prop. Treas. Reg. § 1.170A-1, 83 Fed. Reg. 43563, 43565, 43571 (Aug. 27, 2018). That has no basis in law or economic fairness.

Worst of all, the IRS's approach is a far cry from the statutory language it's supposed to be implementing. Section 170 "allow[s] as a deduction any charitable contribution . . . made within the taxable year." I.R.C. § 170(a)(1). Nothing in Section 170 provides a basis for a rule requiring taxpayers to subtract the value of tax benefits—whether in the form of credits or deductions—from their charitable deductions. Indeed, the very purpose of Section 170 is to encourage charitable giving through the provision of tax benefits. As a consequence, as noted above, judicial precedent and administrative guidance have unanimously affirmed the principle that the expectation of a tax benefit does not give rise to a *quid pro quo* that would negate charitable intent or reduce the amount of a charitable deduction. *See, e.g.*, *Browning*, 109 T.C. at 325; *McLennan*, 24 Cl. Ct. at 106 n.8; *Transamerica*, 15 Cl. Ct. at 465; *Skripak*, 84 T.C. at 319; IRS CCA 201105010.

Had Congress wished to revise the Code so as to reverse this longstanding precedent, it would have done so in clear terms. It has not done so, including in the most recent federal tax overhaul. Rather, members sponsoring that overhaul legislation repeatedly stressed that the legislation kept the charitable deduction under Section 170 in place. As House Speaker Paul Ryan explained: "[T]he Tax Cuts & Jobs Act preserves the deduction for charitable giving."[2] House Ways & Means Committee Chairman Kevin Brady (R-Tex.) likewise stressed: "Preserving and expanding the charitable deduction will continue to encourage and reward Americans who give back to their local church, charity, or other cause they believe in."[3] Senate Finance Committee Chairman Orrin Hatch (R-Utah) likewise stressed that the bill "preserves . . . the deduction for charitable contributions."[4] *See also, e.g.*, 163 Cong. Rec. S7873 (Statement of Sen. Hoeven (R-ND)) ("We continue the deductibility of charitable contributions."). The bill did make some changes to Section 170, e.g., increasing the percentage of a taxpayer's income that can be deductible under Section 170 for cash donations and preventing taxpayers from claiming amounts paid for college athletic event seating rights. Pub. L. No. 115-97, §§ 11023, 13704; H.R. Rep. 115-466 (Conference Report), at 273. These changes reinforce that Congress knew how to modify Section 170—even to account for value received in exchange for certain kinds of donations. But Congress did not change Section 170 to establish that receipt of a state or local tax benefit would constitute a *quid pro quo* negating charitable intent. It is not within the IRS's rulemaking power to usurp Congressional authority and overrule a tax law principle that has been unquestioned for more than 100 years. *See, e.g.*, *Commodity Futures Trading Comm'n v. Schor*, 478 U.S. 833, 846 (1986) ("It is well established that when Congress revisits a statute giving rise to a longstanding administrative interpretation without pertinent change, the 'congressional failure to revise or repeal the agency's interpretation is persuasive evidence that the interpretation is the one intended by Congress.'") (citation omitted).

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[2] Speaker Paul Ryan, Twitter, Nov. 28, 2017, 8:01AM, https://twitter.com/SpeakerRyan/status/935539184437260288.

[3] Chairman Kevin Brady, Twitter, Dec. 25, 2017, 11:30AM, https://twitter.com/RepKevinBrady/status/945376100535894016.

[4] Chairman Orrin Hatch, Remarks Opening Finance Committee Markup of Tax Cuts and Jobs Act, Nov. 13, 2017, https://www.finance.senate.gov/chairmans-news/hatch-opening-statement-at-finance-committee-markup-of-tax-cuts-and-jobs-act.

The IRS's proposal is especially unfair because it disfavors state and local governments relative to the federal government. Because the NPRM addresses *state and local* tax credit programs, *federal* deductions continue to operate under pre-existing law, which treats tax benefits as reductions in tax liability rather than as a *quid pro quo*. *See, e.g.*, *Randall v. Loftsgaarden*, 478 U.S. 647, 657 (1986); *Tempel*, 136 T.C. at 350; Rev. Rul. 79-315, 1979-2 C.B. 27, at 4. Thus, while the receipt of SALT credits would reduce or eliminate a charitable deduction, charitable donations that trigger federal tax benefits would remain fully deductible. Such disparate treatment of substantially similar tax benefits improperly disfavors state tax systems and is the essence of arbitrary and capricious rulemaking. The IRS has presented no viable rationale for treating state and local tax incentives less favorably than federal incentives. *See Davis v. Michigan Dep't of Treasury*, 489 U.S. 803, 815-16 (1989) (observing that "imposition of a heavier tax burden on [those who deal with one sovereign] than is imposed on [those who deal with the other] *must be justified by significant differences between the two classes*") (emphasis added). And it turns the typical analysis—in which states receive favored treatment, *see Massachusetts v. EPA*, 549 U.S. 497, 520 (2007) (asserting that states are "entitled to special solicitude"); *New York v. United States*, 505 U.S. 144, 188 (1992) (noting that states "are not mere political subdivisions of the United States")—entirely on its head.

In sum, the IRS's decision to treat SALT credits as creating economic value to taxpayers, while declining to treat any deductions as creating economic value, is arbitrary, capricious, and contrary to Section 170 of the Tax Code.

b. <u>The Proposed Rules Would Discriminate Against State and Local Governments.</u>

Not only would the IRS's proposed rules violate black letter tax law, but they would also arbitrarily single out state and local tax benefits for unfavorable treatment. The proposed rules would not merely disfavor state and local governments relative to the federal government (by, as explained above, giving full effect only to the latter's tax benefits), but also relative to *foreign* governments. While the proposal would force taxpayers to subtract the value of SALT credits from their charitable deductions, it would continue to permit full deductions in the case of foreign tax benefits. Not only is such discrimination against states and localities arbitrary and capricious—it also violates federalism principles that are key to our constitutional system.

Pursuant to treaties with Canada, Mexico, and Israel, U.S. taxpayers with source income in those countries may claim a charitable deduction under Section 170 for contributions made to qualifying Canadian, Mexican, and Israeli organizations.[5] *See* IRS Publication 526: Charitable Contributions (2017), at 2-3 (outlining rules for deducting such foreign contributions). These contributions reduce the donor's tax liability in the foreign jurisdiction. Under Canadian law, for instance, donors receive a tax credit worth 29 percent of contributions that exceed $200.[6] Israeli

[5] *See* Convention with Respect to Taxes on Income and on Capital, U.S.-Can., Sept. 26, 1980, 1986-2 C.B. 258, art. 21, para. 5; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Mex., Sept. 18, 1992, 1994-2 C.B. 424, art. 22, para. 2; 1980 Protocol, U.S.-Isr., May 30, 1990, 1975 U.S.T. Lexis 594, art. 15A(1) (Protocol to Convention with Respect to Taxes on Income, U.S.-Isr., Nov. 20, 1975).

[6] *See* Income Tax Act, R.S.C. 1985, c. 1, § 118.1(3) (5th Supp.).

tax law entitles donors to credits worth up to 35 percent of the contribution amount.[7] Under Mexican Law, taxpayers may deduct charitable contributions up to seven percent of their taxable income.[8] Yet while the IRS would require taxpayers to subtract the value of SALT credits from their charitable deductions, no such reduction is required for Canadian, Mexican, or Israeli tax benefits.[9] Such disfavoring of states and localities is indefensible. The proposed regulations do not merely fail to safeguard the special position of states within our constitutional structure. Their effect would be to disfavor states and localities relative to foreign countries.

Not only is that unfair to states, but it also makes little sense under basic tax principles. Under the proposed rules, whether a taxpayer could fully deduct a charitable donation would turn on the *source* of the tax benefit in question. Where SALT credits would reduce or eliminate the federal deduction, foreign tax benefits would leave the federal deduction intact. The IRS has given no good reason for that distinction. Whether a return benefit gives rise to a *quid pro quo* that eliminates or reduces a charitable deduction depends not on the source of the benefit but on the value to the donor. *Singer Co. v. United States*, 196 Ct. Cl. 90, 106 (1971); Rev. Rul. 67-246, 1967-2 C.B. 104, at 18.

These arbitrary distinctions also violate the plain language of Section 170, which has no preference for foreign tax incentives over those created by states and localities. To the contrary, it designates as qualifying institutions a "State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia," without favor or prejudice to any of them. I.R.C. § 170(c). Nevertheless, the proposed rules effectively amend this provision to "allow[] as a deduction any charitable contribution, net of state and local tax credits when such credits exceed 15 percent of the contribution amount, and excluding from this calculation tax benefits conferred by the federal government or foreign states." This revision runs afoul of the "federalism canon" of statutory construction, which holds that "Congress does not readily interfere with states' substantial sovereign powers under our constitutional scheme." *American Farm Bureau Fed'n v. EPA*, 792 F.3d 281, 301 (3d Cir. 2015).

In effect, the proposed rulemaking establishes a tax incentive hierarchy wherein programs enacted by state and local governments occupy the bottom rung, below not just federal but also foreign programs. Such discriminatory treatment of state and local government programs cannot withstand even the most deferential scrutiny. The IRS should abandon the proposed regulations and reaffirm the full deductibility of charitable donations that trigger SALT credits, consistent with the treatment of foreign tax benefits.

[7] *See PricewaterhouseCoopers Worldwide Tax Sumaries: Israel, Other Tax Credits and Incentives* (last reviewed September 12, 2018), http://taxsummaries.pwc.com/ID/Israel-Individual-Other-tax-credits-and-incentives.

[8] *See* Council on Foundations, *Mexico* (current as of January 2018), https://www.cof.org/content/mexico.

[9] *See* IRS Publication 597: Information on the United States-Canada Income Tax Treaty (Oct. 2015), at 4 (advising taxpayers that "[u]nder certain conditions, contributions to qualified U.S. charitable organizations may also be claimed on your Canadian income tax return if you are a Canadian resident").

c. The Proposed Rules, Coupled With the IRS's "Clarification" for Business Taxpayers, Would Privilege Corporations Over Individuals.

Viewed in tandem with a "clarification" issued by the IRS on September 5, 2018, the proposed rules arbitrarily and improperly favor businesses over individual taxpayers. In a notice entitled "Clarification for business taxpayers: Payments under state or local tax credit programs may be deductible as business expenses," the IRS announced that "[b]usiness taxpayers who make business-related payments to charities or government entities for which the taxpayers receive state or local tax credits can generally deduct the payments as business expenses." IR-2018-178, Sept. 5, 2018. In an accompanying press release, Secretary of the Treasury Steven Mnuchin added that "[t]he IRS clarification makes clear that the longstanding rule allowing businesses to deduct payments to charities as business expenses remains unchanged after the Tax Cuts and Jobs Act." Press Release, Treasury Secretary Mnuchin Statement on Clarification for Business Taxpayers: Contributions Under State and Local Tax Credit Programs Generally Deductible as Business Expenses (Sept. 5, 2018). "The recent proposed rule concerning the cap on state and local tax deductions," Secretary Mnuchin continued, "has no impact on federal tax benefits for business-related donations to school choice programs." *Ibid.*

The IRS's "clarification" creates an arbitrary, illogical, and untenable distinction between business taxpayers and individual taxpayers. Under Section 162 of the Code, business taxpayers may deduct from taxable income the "ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business[.]" I.R.C. § 162(a). To qualify for the deduction, expenses must have a "legitimate business purpose." *Neonatology Associates, P.A. v. Commissioner*, 115 T.C. 43, 93 (2000). For most businesses, charitable contributions that trigger SALT credits are not "ordinary and necessary . . . in carrying on any trade or business," nor do they serve a "legitimate business purpose." I.R.C. § 162(a); *Neonatology Associates*, 115 T.C. at 93. It is thus puzzling that the IRS would issue such a "clarification." Secretary Mnuchin's invocation of a "longstanding rule allowing businesses to deduct payments to charities as business expenses" only adds to the confusion—no such "longstanding rule" exists. The Secretary's special focus on "business-related donations to school choice programs," moreover, suggests that the IRS may be contemplating special-interest carve-outs for particular charitable contribution programs. It appears, therefore, that the IRS is unwilling to apply the logic of its own reasoning to businesses—and in particular businesses that donate to certain programs. Any attempt to give businesses a back door way effectively to claim charitable deductions for donations to certain entities while barring individuals from doing so merely confirms that the underlying rule is arbitrary, capricious, and unlawful. The idea that individual taxpayers receive an "accession to wealth" from SALT credits, but that businesses do not, is patently meritless.

Although the NPRM's entire analysis of the treatment of SALT credits for charitable contributions is deeply flawed, it is now apparent that the IRS is planning to make things even worse. The IRS was right to recognize that it cannot properly distinguish between new state and local tax credit programs and preexisting ones that predate the cap on the SALT deduction. *See* Prop. Treas. Reg. § 1.170A-1, 83 Fed. Reg. 43563, 43565 (Aug. 27, 2018) (stating that "these proposed regulations . . . apply equally to taxpayers regardless of whether they are participating in a new state and local tax credit program or a preexisting one"). But before the ink was dry on the NPRM, the IRS and the Treasury Secretary immediately began playing politics, attempting to favor some taxpayers over others, and shielding some favored programs from the logic and effect of their own newly proposed rules. Allowing any of these political gimmicks into the final NPRM would demonstrate beyond peradventure that the NPRM is improperly legislative in nature and contrary to Section 170.

II. THE PROPOSED RULES ARE CONTRARY TO PUBLIC POLICY.

The proposed rules are also misguided as a matter of public policy. By depriving state and local governments of important sources of revenue, the proposed rules threaten state and local autonomy, undermining the Constitution's system of federalism. These rules would upset the status quo for individuals, charities, and governments that have come to depend on existing programs. Furthermore, they would create thorny administrative problems for both taxpayers and the IRS, requiring both to wade into complicated questions of state and local tax law simply to determine the amount of an individual's charitable deduction. We urge the IRS to abandon the proposed regulations and return to its fair and administrable practice of allowing full deductions for charitable donations that trigger tax benefits.

a. <u>The Proposed Rules Would Undermine Federalism and State Sovereignty.</u>

To promote charitable giving to philanthropic institutions ranging from environmental conservation groups and domestic violence shelters to financial aid for higher education, 33 states have developed more than 100 programs that offer SALT credits for charitable donations to qualifying institutions.[10] These states established such programs for the same reason that motivated the creation of the charitable deduction in 1917, only four years after the enactment of the first progressive federal income tax in 1913.[11] That is, charitable tax credit programs—like the charitable contribution deduction—encourage charitable giving and citizen engagement, bind communities together, ensure the financial viability of philanthropic organizations, relieve the burdens on state and local governments, and promote a vibrant civil society.[12] In 2011, the IRS approved full deductibility for such programs, and the Tax Court followed suit. *Tempel*, 136 T.C. at 351 n.17; IRS CCA 201105010. The proposed rules would upend these programs, all but nullifying the will of state legislatures across the country.

The resulting harm to individuals, charities, and governments will be especially great in light of the recently enacted $10,000 cap on the federal deduction for state and local taxes. *See* Tax Cuts and Jobs Act ("TCJA"), Pub. L. No. 115-97, § 11042, 131 Stat. 2054, 2085-86 (2017) (codified as amended at 26 U.S.C. §164(b)(6)). To ease the burden of the TCJA's cap on the SALT deduction, several states have established programs that entitle taxpayers to SALT credits

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[10] *See* Bankman, et al., *State Responses to Federal Tax Reform: Charitable Tax Credits*, *supra* note 1 at 641-42, 655.

[11] *See* Harvey P. Dale & Roger Colinvaux, *The Charitable Contributions Deduction: Federal Tax Rules*, 68 TAX LAW 331, 332 n.3 (2015).

[12] *See* Peter J. Wiedenbeck, *Charitable Contributions: A Policy Perspective*, 50 MO. L. REV. 85, 92-96 (1985).

for contributions to charitable funds established by state and local governments.[13] Most of these programs do not provide dollar-for-dollar tax credits and therefore yield a net increase in state and local revenues.[14] New Jersey's program, for instance, entitles taxpayers to a maximum property tax credit of 90 percent of the amount of local charitable donations. N.J.S.A. § 54:4-66.9. With the immense financial pressure on state and local budgets, a net increase in revenue will enable states and localities to increase funding for vital government services—precisely the effect Congress intended when it permitted deductions for charitable contributions to state and local governments under Section 170. *See* I.R.C. § 170(c). The proposed rules would deprive states and localities of these vital revenues.

The effect of the cap on the SALT deduction will be to increase the cost of state and local taxes, potentially forcing states and localities to confront difficult choices regarding tax rates and public services. The proposed rules would only compound this strain on state and local finances. It was precisely to avoid this outcome that the very first federal income tax in the United States, instituted under the Revenue Act of 1862 ("Revenue Act"), contained a SALT deduction.[15] As Representative John Smith Morrill of Vermont put the point when debating the Act, the inclusion of a SALT deduction was "of vital importance," for "the General Government should not absorb all [the states'] taxable resources."[16] The "accustomed objects of State taxation," Morrill added, "should, in some degree at least, go untouched. The orbits of the United States and the States must be different and not conflicting. Otherwise, we might perplex and jostle, if we did not actually crush, some of the most loyal States of the Union."[17] The same principle applies today. By lessening the burden of state and local taxes, the SALT deduction empowers states to sustain vital government programs and perform their constitutional role as "laboratories of democracy" without imposing too great a cost on state and local taxpayers. The cap on the SALT deduction does the opposite, increasing the burden on state and local taxpayers and restricting states' and localities' freedom of action.

It is telling that the NPRM does not even mention the impact of the proposed regulations on state and local finances. To the extent that it addresses the fiscal impact of the proposed rules at all, it cites the Joint Committee on Taxation's estimate that the TCJA's $10,000 limitation on the SALT deduction will generate $668 billion for the federal government over ten years. Prop. Treas. Reg. § 1.170A-1, 83 Fed. Reg. 43563, 43565 n.1 (Aug. 27, 2018). But the IRS has made no attempt to determine how much of that $668 billion would be lost by continuing to recognize the full deductibility of contributions to state and local governments—the financial question relevant to this proposal. Given the complexity of the TCJA, and the increase in the standard

[13] Joseph Bankman, David Gamage, Jacob Goldin, Daniel J. Hemel, Darien Shanske, Kirk J. Stark, Dennis J. Ventry Jr., and Manoj Viswanathan, *Caveat IRS: Problems with Abandoning the Full Deduction Rule*, 88 TAX NOTES 547, 547 n.1 (2018).
[14] *See* Joseph Bankman, David Gamage, Jacob Goldin, Daniel Hemel, Darien Shanske, Kirk J. Stark, Dennis J. Ventry Jr., and Manoj Viswanathan, *State Response to Federal Tax Reform*, 88 TAX NOTES 557 (2018).
[15] Sarah F. Liebschutz & Irene Lurie, *The Deductibility of State & Local Taxes*, 16 PUBLIUS 51, 51-53 (1986).
[16] *Id.* at 52-53.
[17] *Ibid.*

deduction (which will lead far fewer taxpayers to itemize their deductions and thus be eligible to deduct charitable contributions at all), the $668 billion figure cited in the NPRM is meaningless. And the IRS has failed to even attempt to estimate the costs to states and localities from the massive change proposed to the deductibility of contributions to more than 100 programs in 33 states. By failing to undertake any meaningful estimate of the costs and benefits of its proposal, the IRS has once again acted arbitrarily and capriciously.

The IRS's NPRM demonstrates no respect for federalism principles, under which states are not "mere political subdivisions of the United States," but rather are entitled to the "special solicitude" befitting sovereign entities. *See Massachusetts*, 549 U.S. at 520; *New York*, 505 U.S. at 188. Thus, we urge the IRS to respect the federalism principles embodied in the United States Constitution and abandon the proposed regulations.

b. <u>The Proposed Rules Would Upset The Status Quo For Individuals, Charities, And Governments, And Would Not Be Administrable.</u>

The proposed rules would undermine more than 100 charitable tax credit programs on which individuals, charities, and state and local governments in 33 states have come to depend.[18] As the IRS acknowledges, a rule exempting charitable tax credit programs that predate the TCJA would conflict with the tax principles on which the proposed rules purport to rely. Prop. Treas. Reg. § 1.170A-1, 83 Fed. Reg. 43563, 43565 (Aug. 27, 2018). Accordingly, the proposed rules encompass both pre- and post-TCJA charitable tax credit programs. Simply put, their effect would be to dismantle numerous programs that have benefitted individual taxpayers, charitable institutions, and state and local governments for many years. That adjustment would present significant challenges, because charities and governments would struggle to compensate for the shortfall and to communicate to donors that their contributions will no longer entitle them to a deduction. Donors, for their part, will have to acquaint themselves with the new regulations and look elsewhere for their charitable giving—or stop their charitable giving altogether. The IRS failed to grapple with these reliance interests in making its decision—and they are weighty. It is precisely to avoid such consequences that agencies are called on to maintain "consistency with earlier . . . pronouncements." *Skidmore*, 323 U.S. at 140.

In the 101-year history of the charitable contribution deduction, the IRS has never required taxpayers to subtract the value of tax benefits from their charitable contribution deductions. This longstanding practice is rooted in compelling policy considerations. The incentive for charitable giving inherent in the charitable contribution deduction depends on the donor's ability to estimate the value of the deduction with a fair degree of accuracy.[19] Requiring the donor to calculate the value of a federal deduction would add complexity and confusion to the donor's calculus, potentially deterring charitable giving.[20]

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[18] Bankman, et al., *State Responses to Federal Tax Reform: Charitable Tax Credits*, *supra* note 1, at 655.
[19] Bankman, et al., *Caveat IRS: Problems with Abandoning the Full Deduction Rule*, *supra* note 12, at 552.
[20] *Ibid.*

Subtracting the value of SALT credits from charitable deductions would pose equally vexing administrative problems for both taxpayers and the IRS. The value of a SALT credit often hinges on the particulars of state and local tax law—including rules limiting the amount taxpayers may claim in credits, linking credit percentages to the size of a contribution, restricting the ability to carry forward unused credits, and adjusting the value of credits based on the taxpayer's filing status.[21] Thus, a donor would not know the true value of a SALT credit—and, by extension, the amount of her federal charitable deduction—until after she has filed her state income tax return for the year in question.[22]

Furthermore, since state tax law often uses calculations from federal tax law, the proposed rules would create a "catch 22" for many taxpayers who would not be able to determine the value of a federal charitable deduction without first filing their state tax returns (so as to ascertain the true value of the SALT credit), but they would not be able to file their state tax returns without first filing their federal tax returns (which supply many of the calculations—e.g., taxable income and adjusted gross income—for state tax returns). Such a disruption to the status quo is bound to create confusion and frustration for taxpayers and the IRS alike.

Not only would this confusion and uncertainty potentially discourage charitable giving; it would also mire taxpayers and the IRS in the arcana of state and local tax law. A rule permitting full deductions for contributions that trigger SALT credits avoids this administrative morass and maintains continuity with the charitable contribution deduction's 101-year history.

V. CONCLUSION

The proposed rules requiring taxpayers to subtract the value of SALT credits from their charitable contribution deductions are arbitrary and capricious, an exercise in law-making rather than statutory interpretation, and contrary to public policy. The IRS should abandon its proposed rules and restore its previous practice of allowing full deductions for charitable contributions that trigger SALT credits.

Sincerely,

Gurbir S. Grewal
Attorney General of New Jersey

Xavier Becerra
Attorney General of California

George Jepsen
Attorney General of Connecticut

Barbara D. Underwood
Attorney General of New York

[21] *Id.* at 550-51.
[22] *Ibid.*