2018

Failed Charity: Taking State Tax Benefits Into Account for Purposes of the Charitable Deduction

Roger Colinvaux
The Catholic University of America, Columbus School of Law

Buffalo Law Review

VOLUME 66 AUGUST 2018 NUMBER 4

Failed Charity: Taking State Tax Benefits into Account for Purposes of the Charitable Deduction

ROGER COLINVAUX†

ABSTRACT

The Tax Cuts and Jobs Act (TCJA) substantially limited the ability of individuals to deduct state and local taxes (SALT) on their federal income tax returns. Some states are advancing schemes to allow taxpayers a state tax credit for contributions to a charity controlled by the state. The issue is whether state tax benefits are deductible as a charitable contribution for purposes of the federal income tax. Under a general rule of prior law—the full deduction rule—state tax benefits were ignored for purposes of the charitable deduction. If the full deduction rule is applied to the state workaround schemes, then the SALT limitation can successfully be avoided. This Article explains that after the TCJA, the legal basis for the full deduction rule is undermined. The IRS articulated the full deduction rule given the longstanding baseline of deductible state tax payments. Thus, to allow a charitable deduction for state tax benefits under prior law was simply to allow a deduction for an otherwise deductible expense. After the

†Roger Colinvaux. Professor of Law, Columbus School of Law, The Catholic University of America; Legislation Counsel, Joint Committee on Taxation 2001–2008.

Thanks to John Colombo and Daniel Halperin for comments on an early draft of this Article and, for comments on a subsequent version, to participants of the mini conference: *Rebelling Against a SALT-Free Diet with Charitable Contributions—Does that Work?*, sponsored by the National Center on Philanthropy and the Law at New York University School of Law (May 23, 2018). Thanks also to Rachel Goloff for research assistance.

TCJA, this symmetry with the SALT deduction is gone and the full deduction rule is of questionable applicability. A charitable deduction for state tax benefits would allow taxpayers to deduct amounts not spent and even to profit from charitable transfers. The charitable deduction is intended to encourage giving, not tax avoidance. Thus, the Treasury Department and the courts should apply a longstanding principle of charitable contribution law that measures a contribution by the amount of taxpayer sacrifice. After the TCJA, a contribution should be reduced by the value of state tax benefits, whether the benefits take the form of a credit or a deduction. The reasoning applies both to state workaround credits (and deductions) and to existing state tax benefits that previously have been deducted as charitable. Further, denying a charitable deduction for previously deductible expenses is in fact consistent with the status quo prior to the TCJA, in that, given the loss of a SALT deduction, the charitable deduction was an offset that did not provide a meaningful benefit to taxpayers.

INTRODUCTION

The Tax Cuts and Jobs Act (TCJA)[1] limited the federal income tax itemized deduction for state and local taxes (SALT or the "SALT deduction") to $10,000 annually.[2] As a result, taxpayers who formerly deducted state and local taxes in excess of $10,000 lose a significant tax benefit.[3] In response, some state governments have enacted workarounds to preserve the federal deductibility of payments that inure to the benefit of the state and other

1. Pub. L. No. 115-97, 131 Stat. 2054 (2017) (codified as amended in scattered sections of 26 U.S.C.). The official title of the legislation is "An act to provide for reconciliation pursuant to Titles II and V of the concurrent resolution on the budget for fiscal year 2018."

2. *Id.* § 11042 at 2085–86. For married taxpayers filing separately, the limit is $5,000. The limitation expires for taxable years beginning on or after January 1, 2026.

3. If such taxpayers continue to itemize, the amount no longer deductible is the amount of taxes paid less $10,000. If such taxpayers take the standard deduction ($24,000 for a couple filing jointly and $12,000 for singles), then the amount no longer deductible depends on various factors. For example, if a couple filing jointly took the standard deduction of $24,000 and had no other potentially deductible expenses (e.g., mortgage interest, charitable contributions), then the amount no longer deductible to them would be the amount of taxes paid less $24,000).

states are considering similar legislation.[4]

The general approach is for a state to provide a tax credit for payments to a charity[5] that is controlled by the state.[6] If the payment qualifies as a charitable contribution,[7] then the payment is deductible for federal income tax purposes. The workarounds thus contemplate the recharacterization of nondeductible state tax payments as deductible charitable contributions. The Treasury Department has announced its intention to issue proposed regulations on the tax treatment of these types of arrangements.[8]

The issue raised by the workarounds is whether a taxpayer's receipt of state tax benefits in connection with a payment to charity affects the allowance of a charitable deduction. If state tax benefits are ignored for charitable contribution purposes, then the workarounds will succeed in avoiding the SALT limitation. If, on the other hand, state

4. Connecticut, New Jersey, New York, Connecticut and Oregon have enacted workaround credit schemes. *See, e.g.*, Ryan Hutchins, *New Jersey Legislature Passes SALT Workaround*, POLITICO (Apr. 12, 2018, 7:23 PM), https://www.politico.com/states/new-jersey/story/2018/04/12/new-jersey-legislature-passes-salt-workaround-362279; Gerald B. Silverman, *New York Legislature Enacts Major Tax Overhaul*, BNA (Apr. 2, 2018), https://www.bna.com/new-york-legislature-n57982090688/.

5. "Charity" in this Article is shorthand for an organization eligible to receive deductible contributions. I.R.C. § 170(c) (2012). Charities include most organizations described in § 501(c)(3) of the Internal Revenue Code, and need not be charitable but may be organized for a variety of purposes, including charitable, educational, scientific, religious, and literary. *Id.* § 501(c)(3). Charities for this purpose also include government entities. *Id.* § 170(c)(1).

6. New York takes a variety of approaches. Taxpayers may receive an 85% credit on state income taxes for contributions to a state fund with separate accounts for health and education, or for donations to a private nonprofit that supports the State University of New York or the City University of New York. *See* S.B. S7509-C, 2017–2018 Reg. Sess. (N.Y. 2018).

7. I.R.C. § 170(c).

8. I.R.S. Notice 2018-54, 2018-24 I.R.B., https://www.irs.gov/irb/2018-24_IRB (describing the workaround credits as an effort by states to "circumvent the new statutory limitation on state and local tax deductions").

tax benefits are relevant for purposes of determining a charitable contribution, then the workarounds will provide a reduced or no federal tax benefit.

Importantly, the issue is not limited to the state workaround credits, but bears directly on a wide array of other state tax credit programs that link state tax benefits to payments to a charity. Some states for example offer a 100% credit for payments to independent charitable organizations (i.e., charities not controlled by the state).[9] To the extent state tax benefits are not deductible charity as part of a SALT workaround, the same reasoning for nondeductibility applies to these other types of payments. Thus, how the Treasury Department (and ultimately the courts) resolve this issue has implications not just for the federal tax treatment of the workaround schemes but for many existing state credits and deductions.

In weighing the issues, it is important to consider how state tax benefits historically have been treated for charitable deduction purposes. In general, prior to the TCJA, a full federal charitable deduction was allowed notwithstanding the receipt of state tax benefits for the contribution,[10] i.e., state tax benefits were ignored for charitable deduction purposes. This position was recently coined as the "full deduction rule" in an article by several law professors.[11] The question is whether the full deduction

---

9. Many of these credits are listed in the appendix to Joseph Bankman, et al., *State Response to Federal Tax Reform: Charitable Tax Credits*, 159 TAX NOTES 641 (2018) [hereinafter *FDR Paper*].

10. I.R.S. Chief Couns. Adv. Mem. 201105010 (Feb. 4, 2011) [hereinafter 2011 CCA].

11. *FDR Paper*, *supra* note 9; *see also* Kirk J. Stark, *Tax Treatment of Charitable Contributions & State Tax Credits*, 9 COLUM. J. TAX. L. TAX MATTERS 1 (2018). For convenience, this Article adopts the term "full deduction rule" though its status as a widely known or understood rule is debatable. As the authors of the *FDR Paper* note, as of 2011 "there was no judicial authority directly addressing the full deduction rule." *FDR Paper*, *supra* note 9, at 646. For additional commentary, *see* David Gamage, *Charitable Contributions in*

rule survives the TCJA. If so, then a charitable deduction of the entire amount paid to charity may be available notwithstanding the receipt of substantial tax benefits.[12]

This Article argues that a collateral effect of the TCJA is to change the full deduction rule. As the Article explains, the Internal Revenue Service (IRS) articulated the full deduction rule in reliance on the longstanding legal baseline of federally deductible state tax payments.[13] Before the TCJA, any reduction in state tax liability (because of a state deduction or credit) meant a corresponding reduction to a taxpayer's SALT deduction. Thus, when a transfer resulted in a state tax benefit under prior law, a federal charitable deduction for the value of the state tax benefit was offset by a lower SALT deduction.[14] This pre TCJA

Lieu of SALT Deductions, 87 ST. TAX NOTES 973 (2018); JARED WALCZAK, TAX FOUND., STATE STRATEGIES TO PRESERVE SALT DEDUCTIONS FOR HIGH-INCOME TAXPAYERS: WILL THEY WORK? 4 (2018), https://files.taxfoundation.org/20180105094213/Tax-Foundation-FF569.pdf; Amandeep S. Grewal, *The Charitable Contribution Strategy: An Ineffective SALT Substitute*, 38 VA. TAX. REV (Forthcoming 2018 [hereinafter Grewal, *Ineffective SALT Substitute*]; Eric Bennett Rasmussen, *Getting Around the State and Local Tax Deduction Limit* (Jan. 9, 2018) (unpublished manuscript) (available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3099296); Andy Grewal, *Can States Game the Republican Tax Bill with the Charitable Contribution Strategy?*, YALE J. ON REG.: NOTICE & COMMENT (Jan. 3, 2018), http://yalejreg.com/nc/can-states-game-the-republican-tax-bill-with-the-charitable-contribution-strategy/.

12. The authors of the *FDR Paper* believe that the deductibility of payments pursuant to state workaround schemes generally should withstand administrative and judicial challenge, except perhaps in the case of a 100 percent state credit. *FDR Paper*, *supra* note 9, at 642. There are other possible ways to attack the state workaround credits. Professor Grewal for example argues that the Treasury Department should use a substance over form approach. Grewal, *Ineffective SALT Substitute*, *supra* note 11, at 2 (discussing different approaches and concluding that "nominal donations to state-controlled funds should be treated as the payment of state taxes").

13. *See* discussion *infra* Section II.A.

14. *See* discussion *infra* Section II.A. For alternative minimum tax taxpayers, however, the charitable deduction represented a gain, not an offset to the loss of a SALT deduction. This is because the SALT deduction is not available for alternative minimum tax (AMT) taxpayers while the charitable

symmetry appears to be a main reason the IRS decided that state tax benefits could be deducted as charitable contributions. After the TCJA, however, this symmetry is gone. Accordingly, the ongoing validity of the full deduction rule is doubtful and has little to no bearing on how state tax benefits should be treated after the TCJA.

The TCJA's mooting of the full deduction rule means that the treatment of tax benefits for charitable contribution purposes is an open question. In deciding the issue, the Treasury Department and the courts should follow a longstanding principle of charitable contribution law, namely that a contribution is measured by the extent to which a taxpayer has given something away. When a taxpayer receives state tax benefits for a contribution, the cost to the taxpayer, i.e., the taxpayer's sacrifice, is reduced. Thus, a contribution for tax purposes should not include the value of tax benefits received. The full deduction rule is not a barrier to this result.

Indeed, after the TCJA, to ignore tax benefits as return benefits would convert the charitable contributions deduction from an incentive to give into an incentive to profit. This could occur because the state workaround credits and many other state tax credits potentially become economic windfalls that would make taxpayers better off. For example, under a 100% state tax credit program, if a taxpayer transfers $100 to charity the taxpayer could receive $137 as a direct result. Any reasonable construction of the meaning of a "contribution" for purposes of the charitable deduction does not include such windfalls. In the words of the Supreme Court, if a transfer improves a taxpayer's economic position, the transfer is not "unrequited" because the "external features" of the

---

deduction is available. *See* SASHA PUDELSKI & CARL DAVIS, INST. ON TAX'N & ECON. POL'Y, PUBLIC LOSS PRIVATE GAIN: HOW SCHOOL VOUCHER TAX SHELTERS UNDERMINE PUBLIC EDUCATION4 (2017), https://itep.org/wp-content/uploads/AASA_Public_Loss_Private_Gain_F2.pdf.

transaction show a net benefit to the taxpayer.[15] The full deduction rule should not and need not be applied beyond its pre-TCJA context to allow the deduction of profit.[16]

Part I of the Article provides an overview of the meaning of a "contribution" for purposes of the charitable deduction. The general principle, as reflected in Supreme Court jurisprudence, is that a contribution reflects a notion of sacrifice, i.e., a contribution is the amount a taxpayer gives away. Part II discusses the full deduction rule and shows that the TCJA casts serious doubt on its ongoing validity both as a matter of law and in light of congressional intent. Part II also explains that the Treasury Department and the courts should characterize state tax benefits as return benefits that reduce the amount of, or eliminate, the charitable deduction. Doing so sensibly reflects the longstanding definition of a contribution as the amount sacrificed by the taxpayer. To do otherwise, would convert the charitable deduction into an instrument of profit, not an incentive to give. Part III extends the analysis to state tax benefits other than the workaround credits and briefly considers administrative concerns. The Article then concludes that state tax benefits should be treated as return benefits for purposes of the charitable deduction.

I. THE MEANING OF CONTRIBUTION AS SACRIFICE

The federal charitable contributions deduction is an incentive to give. From the initial legislative history[17]

---

15. Hernandez v. Commissioner, 490 U.S. 680, 690 (1989).

16. The full deduction rule does not appear to have been applied in cases in which a taxpayer profits from a contribution. The examples explored by the *FDR Paper* authors involve cases where the taxpayer is not better off from the contribution, even after taking tax benefits into account. *See FDR Paper*, *supra* note 9.

17. Speaking on the Senate floor in support of a charitable deduction in 1917, Senator Hollis pronounced:

> After they have done everything else they want to do, after they have

through court decisions, the deduction is described in terms of encouraging taxpayers to make a sacrifice.[18]

As explained below, how to account for benefits that flow to a taxpayer from a transfer is fundamental to the meaning of a contribution. In general, if a taxpayer is better off because of a transfer (i.e., the benefits from a payment exceed the payment), then there is no contribution. When a taxpayer profits, then almost by definition, an incentive is not necessary, there is no contribution, and a deduction should not be allowed. If a taxpayer is not better off from the transfer, and there is intent to make a gift, then the general rule is to measure the contribution by the amount of the transfer less the value of any return benefits received.[19] In such a case, the deductible contribution is the amount of the taxpayer's sacrifice.

These general rules come from the language of the Internal Revenue Code and court decisions. Technically speaking, the Code allows a deduction for a "charitable contribution."[20] In defining the term, Congress provided only that a charitable contribution is a "contribution or gift to or for the use of" an eligible organization[21] and did not define either contribution or gift.[22] Accordingly, over the years, the courts have wrestled with the meaning of the

---

> educated their children and traveled and spent their money on everything they really want or think they want, then, if they have something left over, they will contribute it to a college or to the Red Cross or for some scientific purposes. Now, when war comes and we impose these very heavy taxes on incomes, that will be the first place where the wealthy men will be tempted to economize, namely, in donations to charity. They will say, "Charity begins at home."

55 Cong. Rec. 6728 (1917).

18. *See Hernandez*, 490 U.S. at 690 (summarizing the legislative history of the deduction as being for "unrequited payments").

19. Treas. Reg. § 170A-1(h)(2)(i) (2008); Rev. Rul. 67-246, 1967-2 C.B. 104.

20. I.R.C. § 170(a) (2012).

21. *Id.* § 170(c).

22. *Id.*

terms. One constant is that the taxpayer must have donative intent, with a main legal issue being whether intent is assessed by a subjective or an objective approach.

Early decisions required that a charitable contribution be made with detached and disinterested generosity.[23] This standard was borrowed from a Supreme Court case, *Commissioner v. Duberstein*,[24] which construed the meaning of a gift for purposes of the income tax exclusion.[25] As a general matter, however, the *Duberstein* standard fell out of favor because it relies on determining the subjective intent of the taxpayer, making the test hard to administer.

A leading early case to reject the *Duberstein* approach for charitable contributions was *Singer Co. v. United States*,[26] in which the Claims Court used a return benefit test. Under a return benefit test, instead of examining the taxpayer's motives, the criterion is whether a taxpayer expects to receive return benefits. If so, then the transaction is more like an exchange for value received and not a contribution. An advantage to a return benefit test is that whether there is a return benefit can be determined objectively by looking at the external features of the transaction.

Eventually, the Supreme Court embraced the *Singer* court's approach with two decisions in the 1980s, *United States v. American Bar Endowment*[27] and *Hernandez v.*

---

23. DeJong v. Comm'r, 309 F.2d 373, 377–79 (9th Cir. 1962) (noting that "contribution" and "gift" are synonymous and therefore it was appropriate to apply the standard in Comm'r v. Duberstein, 363 U.S. 278 (1960) on excludable gifts to deductible contributions).

24. 363 U.S. at 287–91.

25. I.R.C. § 102.

26. 449 F.2d 413, 418 (Ct. Cl. 1971) (adopting a quid pro quo test for a contribution and rejecting the *Duberstein* test because "it would then be necessary for us to look to the subjective intent of the plaintiff . . . . This would not be an impossible task, but it would indeed be a very difficult one.").

27. 477 U.S. 105 (1986).

Commissioner.[28] In *American Bar Endowment*, the issue was whether the taxpayers intentionally overpaid a charity for insurance and so were able to deduct the overpayment.[29] The Court held against the taxpayers, setting forth a substantial return benefit standard for a charitable contribution. The Court said that: "[a] payment of money generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return."[30] Here, the taxpayers expected to receive insurance in exchange for the payment to charity—a substantial benefit. Thus, as a threshold matter, there was no contribution.

The Court acknowledged, however, that payments could take on a dual character as part gift and part exchange, leaving the door open to deduct an overpayment as a contribution. The Court provided that:

> a taxpayer may sometimes receive only a nominal benefit in return for his contribution. Where the size of the payment [to charity] is clearly out of proportion to the benefit received [by the donor], it would not serve the purposes of § 170 to deny a deduction altogether. A taxpayer may therefore claim a deduction for the difference between a payment to a charitable organization and the market value of the benefit received in return, on the theory that the payment has the "dual character" of a purchase and a contribution.[31]

Under the Court's approach, in order for part of a dual payment to be deductible, there are two conditions: the payment must exceed the market value of the benefit received and the payment "must be 'made with the intention of making a gift.'"[32] The Court also said: "[t]he

---

28. 490 U.S. 680 (1989).

29. 477 U.S. at 108–09.

30. *Id.* at 116.

31. *Id.* at 117.

32. *Id.* (citing Rev. Rul. 67-246, 1967-2 C.B. 104). This standard was later promulgated in regulations. Treas. Reg. § 1.170A-1(h)(1) (2008) (providing that no part of a payment made in consideration for goods or services is a contribution unless the taxpayer "[i]ntends to make a payment in an amount

taxpayer . . . must at a minimum demonstrate that he purposely contributed money or property in excess of the value of any benefit he received in return."[33]

Two features of the Court's approach are worth noting. One is affirmance of the basic idea that a contribution requires a sacrifice by the taxpayer. The taxpayer must show "at a minimum" that the amount transferred exceeds the value of any return benefit. If there is a substantial return benefit, then there is no sacrifice and no contribution.[34] Another is that donative intent is required, hence the Court's references to the taxpayer's expectations and purpose. However, the test for intent is not a subjective inquiry into the taxpayer's motives but rather is based on objective factors—the presence of return benefits.[35] The Court did not limit the types of benefits that could be considered return benefits.[36]

Three years later, the Court solidified the substantial

---

that exceeds the fair market value of the goods or services" and "[m]akes a payment in an amount that exceeds the fair market value of the goods or services").

33. *Am. Bar Endowment*, 477 U.S. at 118. As applied, the Court found that the taxpayers failed to meet their burden as none showed awareness that similar but cheaper insurance was available elsewhere. Notably, a charitable deduction is not automatic if the amount transferred exceeds the value of benefits received. The taxpayer must be able to demonstrate that the overpayment was intentional.

34. *Id.* at 116.

35. Donative intent is not always easy to reduce to an objective determination. For instance, if a business negotiates a sale to charity where the charity pays less than fair market value, the business is not entitled to deduct the difference absent donative intent to make a contribution, even though the taxpayer did not receive full value. *See* Connell v. Comm'r, 51 T.C.M. (CCH) 1657, 1662 (1986) (holding that the sale of land for less than the appraised value did not yield a charitable contribution because there was no evidence of donative intent to make a gift), *aff'd per curiam*, 842 F.2d 285 (11th Cir. 1988); Stark v. Comm'r, 86 T.C. 243, 256 (1986) ("The taxpayer who negotiates for the best terms he can obtain in a commercial transaction cannot subsequently claim a deduction based upon any excess value of the 'contributed' property over the consideration received . . . .").

36. *See Am. Bar Endowment*, 477 U.S. at 117.

return benefit approach in *Hernandez v. Commissioner*.[37] In *Hernandez*, the Court again rejected subjective motive as the test for the meaning of contribution, noting that the IRS looks to the "external features" of the transfer. External features, the Court said, have the advantage of obviating "the need for the IRS to conduct imprecise inquiries into the motivations of individual taxpayers."[38] The Court also cited 1954 legislative history in which Congress defined gifts as payments "made with no expectation of a financial return commensurate with the amount of the gift."[39] Thus, under both *Hernandez* and *American Bar Endowment*, the Court looked to the external features of a transfer for return benefits, which serve as a proxy for donative intent.

Hernandez and *American Bar Endowment* are known today for the rejection of the *Duberstein* approach and the embrace of an external features or quid pro quo analysis for charitable contributions. The black letter law to emerge from the decisions is: (1) the taxpayer may not receive more than the taxpayer pays, (2) dual character transfers are allowed, and (3) in the case of dual character transfers, the amount of the contribution is the amount of the payment less the value of benefits received.[40]

37. 490 U.S. 680 (1989).

38. *Id.* at 690–91 (noting that the Court also looked to "external features" in *American Bar Endowment*).

39. *Id.* at 690 (citing S. REP. NO. 83-1622, at 196 (1954); H.R. REP. NO. 83-1337, at A44 (1954)). The Court also said: "The legislative history of the 'contribution or gift' limitation . . . reveals that Congress intended to differentiate between unrequited payments to qualified recipients and payments made to such recipients in return for goods or services." *Id.* The Court went on to say unrequited payments are deductible while payments made with an expectation of quid pro quo in terms of goods or services are not. *Id.*

40. Assuming there is a contribution, other rules may apply to limit the amount of the deduction, including caps based on the taxpayer's adjusted gross income, whether the gift is property and if so what type, and the type of donee (a public charity or private foundation). For an overview of applicable rules, see, for example, Harvey P. Dale & Roger Colinvaux, *The Charitable Contributions Deduction: Federal Tax Rules*, 68 TAX LAW. 331 (2015).

The Court, however, did not address all questions. One issue is which benefits count as "external features" of a transaction that reduce or eliminate the deduction. In both *American Bar Endowment* and *Hernandez*, the context is a quid pro quo exchange, meaning that the benefits flow from the recipient charity not a third party.[41] Thus, the Court declares in *American Bar Endowment* the oft-cited statement that: "[t]he *sine qua non* of a charitable contribution is a transfer of money or property without adequate consideration."[42] Similarly, in *Hernandez*, the Court refers to the contractual concept of consideration as important to determining whether a benefit is a relevant external feature of the transaction.[43] The Treasury Regulations subsequently echoed the consideration approach to return benefits, setting forth a legal standard for the deduction when a transaction includes payments that are "in consideration for . . . goods or services."[44] These authorities therefore offer guidance for the typical case of return benefits received from the charity as part of an

---

41. *See Hernandez*, 490 U.S. at 685–86; *Am. Bar Endowment*, 477 U.S. at 107–08.

42. *Am. Bar Endowment*, 477 U.S. at 118.

43. 490 U.S. at 690 (citing Committee report examples of a payment to a hospital as being made "in consideration of a binding obligation to provide medical treatment"). The issue in *Hernandez* was whether the return benefit had to be of an economic nature, or whether return benefits of a religious or spiritual nature were relevant external features of the transaction. *Id.* at 687. The Court found that the religious benefits received "were part of a quintessential *quid pro quo* exchange: in return for their money, petitioners received an identifiable benefit." *Id.* at 691. Importantly, the *Hernandez* Court held that the return benefit did not have to be a financial benefit but could be intangible in nature, thus expanding the scope of relevant benefits beyond the ordinary case. *See id.* 692–93.

44. Treas. Reg. § 1.170A-1(h) (2008) (setting forth the standard for "[p]ayment in exchange for consideration"). The regulations provide that "Goods or services means cash, property, services, benefits, and privileges," *id.* § 1.170A-13(f)(5), and that goods or services of "insubstantial value" are disregarded. *Id.* § 1.170A-13(f)(8)(i)(A).

exchange.[45]

Importantly though, neither the Supreme Court nor the Treasury regulations limit relevant benefits to those received as consideration. Notwithstanding the specific context of *American Bar Endowment* and *Hernandez*, case law provides that the relevant benefits do not have to come directly from the charity but rather flow from the transfer. In other words, both direct and indirect benefits are included when determining the external features of a transaction.[46]

For example, in *Singer*, cited approvingly in *American Bar Endowment*, a sewing machine company sold sewing machines to a charity at a discount.[47] The question was whether the company could deduct the discount as a charitable contribution, i.e., whether this was a dual character payment qualifying for part gift-part sale treatment.[48] The court disallowed the deduction holding

---

45. Relatedly, the substantiation requirements for charitable contributions are directed to quid pro quo exchanges. Donors must substantiate contributions of $250 or more with a contemporaneous acknowledgement from the donee charity. The acknowledgement must indicate whether the donee "provided any goods or services in consideration" for the contribution and if so "[a] description and good faith estimate of the value of any goods or services." I.R.C. §§ 170(f)(8)(B)(ii)–(iii) (2012). Charities are required to inform donors of the amount allowed as a deduction for quid pro quo contributions of more than $75. A quid pro quo contribution for this purpose is defined as "a payment made partly as a contribution and partly in consideration for goods or services provided to the payor by the donee organization." *Id.* § 6115(b).

46. *See* Joseph Bankman, et al., *Caveat IRS: Problems with Abandoning the Full Deduction Rule*, 88 ST. TAX NOTES 547, 548–49 (2018) (noting that the "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," "the law makes no distinction between direct and indirect benefits," and "that the *source* of the benefit received by the donor is relevant") [hereinafter *Caveat IRS*].

47. Singer Co. v. United States, 449 F.2d 413, 422–23 (Ct. Cl. 1971) (looking to the substantiality of all the benefits the taxpayer received).

48. *Id.* at 414, 422–23.

that Singer received a substantial indirect benefit from the sale of the sewing machines in the form of future purchases from the beneficiaries using the machines, i.e., something akin to good will.[49] The benefit was not provided by the charity as part of the exchange, yet nonetheless, the return benefit was a relevant external feature that colored the transfer, with the result that there was no contribution.[50]

Similarly, in *Ottawa Silica Co. v. United States*, the taxpayer donated land to a school.[51] The taxpayer expected that the ownership of the land by the school would increase the value of the taxpayer's property holdings.[52] The court disallowed a charitable deduction for the land because the transaction as a whole provided a net benefit to the taxpayer, notwithstanding the benefit to the charity.[53] In the language of *American Bar Endowment* and *Hernandez*, the "external features"[54] of the transaction showed that the taxpayer "expected a substantial benefit in return."[55] It did not matter that the benefit was not consideration for the payment to charity or that the charity did not provide the benefit.[56]

In addition to not limiting the source of return benefits, the Supreme Court's approach to the meaning of contribution left open the question of what makes a return benefit "substantial" so as to disallow a contribution entirely. The dichotomy established in *American Bar Endowment* is between substantial and nominal benefits, with no deduction for the former, and dual character

49. *Id.* at 424.

50. *Id.* at 423–24.

51. 699 F.2d 1124, 1131 (Fed. Cir. 1983).

52. *Id.* at 1135.

53. *Id.*

54. Hernandez v. Comm'r, 490 U.S. 680, 691 (1989).

55. United States v. Am. Bar Endowment, 477 U.S. 105, 116 (1986).

56. *Ottawa Silica Co.*, 699 F.2d at 1135.

treatment for the latter.[57] The language of *American Bar Endowment* therefore suggests that if a benefit is less than the amount of the payment, but not nominal, no deduction is allowed even though the taxpayer has given something away.[58] In practice, however, the IRS has been inclined to allow a deduction so long as there is significant sacrifice.[59] Notably, absent further direction from the Supreme Court, determining the substantiality of a return benefit has been within the IRS's discretion.[60]

In summary, under prevailing authorities, the test for a contribution is one of substantial return benefit. Donative intent is required but is based upon the external features of the transaction not on a subjective inquiry into the taxpayer's motives. As a general matter, if a taxpayer is better off because of the transfer, then the external features of the transaction suggest that there is no donative intent, and no charitable deduction is allowed even if a charity benefits. Although most of the authorities relate to quid pro quo exchanges where return benefits are provided by the

57. *Am. Bar Endowment*, 477 U.S. at 116–17.

58. Under the "nominal" benefit test, in theory if a benefit is 99% of the payment (e.g., a taxpayer pays $100 to charity and receives $99 in return), a deduction of $1 should not be allowed.

59. Rev. Rul. 67-246, 1967-2 C.B. 104, example 2 (allowing a deduction where return benefit was one-third of the amount paid). The intentionality of an overpayment generally can be shown by the required substantiation whereby the donee charity informs the donor that goods and services were provided in connection with the gift and provides a good faith estimate of the value of the goods and services. I.R.C. § 170(f)(8)(B) (2012). Through this paperwork, the intentionality of an overpayment is established objectively.

60. *See* Rev. Proc. 90-12, 1990-1 C.B. 471 (providing that "charities offering certain small items or other benefits of token value may treat the benefits as having insubstantial value so that they may advise contributors that contributions are fully deductible under section 170"); William A. Drennan, *Where Generosity and Pride Abide: Charitable Naming Rights*, 80 U. CIN. L. REV. 45, 56 (2011) (noting that "the Treasury Department and the IRS have adopted a series of authorities effectively valuing naming rights at zero, which allows naming donors to deduct their total transfers to charity" notwithstanding the receipt of something of contractual value).

charity, indirect benefits also count as external features of a transaction. The courts have not provided a bright line to determine when a return benefit that is less than the amount paid is substantial.

II. STATE TAX BENEFITS AS RETURN BENEFITS

The question presented in the aftermath of the TCJA is whether to take tax benefits into account as relevant external features of a transfer in determining the amount, if any, of a charitable contribution. This part of the Article explains that although tax benefits generally were ignored prior to the TCJA, the TCJA fundamentally has changed the legal landscape by limiting the SALT deduction. This change paves the way for tax benefits to be considered as relevant external features that may and should be taken into account for purposes of determining a contribution under longstanding principles of charitable contribution law.

A. *Contextualizing the Full Deduction Rule*

Prior law (i.e., pre-TCJA law) supports a proposition that has been termed the "full deduction rule" by several law professors in a recent article (the *FDR Paper*).[61] Under the full deduction rule, tax benefits generally are ignored for charitable deduction purposes, in that they neither negate donative intent nor constitute a return benefit that reduces the amount of the deduction. As discussed below, after the TCJA the full deduction rule is best viewed in context and does not provide meaningful authority for ignoring tax benefits when determining the extent of a contribution.

---

61. *FDR Paper*, *supra* note 9, at 642, 654 (stating that the full deduction rule is "well-settled law" supported by "decades of precedent").

1. Relevance of the pre-TCJA legal baseline

The *FDR Paper* emphasizes an IRS Chief Counsel Advice from 2011 (2011 CCA) as "summariz[ing]" "the legal authority supporting the full deduction rule."[62] The issue in the 2011 CCA was whether a transfer to a charity that entitles the taxpayer to a state tax credit should be characterized as a charitable contribution or as a payment of state tax liability.[63] In discussing the issue, the IRS noted that donative intent was required for a charitable contribution, and recited the general rules on donative intent, including the *Singer*, *American Bar Endowment*, and *Hernandez* cases.[64] The IRS concluded 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 itself."[65] On its face, as the *FDR Paper* suggests, this statement supports a full deduction rule, i.e., that tax benefits are ignored for contribution purposes.[66]

---

62. *Id.* at 644 (discussing I.R.S. Chief Couns. Adv. Mem. 201105010 (Feb. 4, 2011)). For additional discussion, see Peter L. Faber, *Comment on Professor Stark's Prompt*, 9 COLUM. J. TAX. L. TAX MATTERS 9, 9 (2018) (noting that the 2011 CCA "is not precedential and does not necessarily state the IRS's official position"); Jared Walczak, *The Ways of Paradox: What Renders a Contribution Deductible?*, 9 COLUM. J. TAX. L. TAX MATTERS 4, 7 (2018) (noting the limitations of the 2011 CCA); Grewal, *Ineffective SALT Substitute*, *supra* note 11, at 8 (noting that "reliance on the memo seems misplaced, however. By law, that memo may not be cited as precedent, and it has no greater authority than other internal IRS memos, including those that express concerns over whether state tax credits negate a taxpayer's charitable intent").

63. 2011 CCA, *supra* note 10, at 2.

64. *Id.*

65. *Id.* A main issue was whether a state tax credit should be treated differently from a state tax deduction. The IRS made a similar statement in CCA 200238041, noting that a state charitable contribution deduction "is not viewed as a return benefit that reduces or eliminates a deduction under § 170, or vitiates charitable intent." I.R.S. Chief Couns. Adv. Mem. 200238041 (Sept. 20, 2002); *see also FDR Paper*, *supra* note 9, at 645 (discussing CCA 200238041).

66. *FDR Paper*, *supra* note 9, at 644–45.

After the TCJA, however, the IRS's articulation of the full deduction rule should be viewed against the then prevailing legal baseline of deductible state taxes. Notably, in the 2011 CCA, the IRS said that "[t]here may be unusual circumstances in which it would be appropriate to recharacterize a payment of cash or property that was, in form, a charitable contribution as, in substance, a satisfaction of tax liability."[67] But, such a recharacterization was not called for at the time because

> [g]enerally . . . a state or local tax benefit is treated for federal tax purposes as a reduction or potential reduction in tax liability. As such, it is reflected in a reduced deduction for the payment of state or local tax under [SALT] not as consideration that might constitute a *quid pro quo*, for purposes of [a charitable contribution].[68]

Thus, the IRS concluded that the state tax benefit was not a return benefit for charitable deduction purposes because the state benefit comes at a cost in the form of a reduced SALT deduction. The IRS noted specifically that the "[t]axpayers are not entitled to a [SALT] deduction for the amount of the state tax credit used to offset their State tax liability."[69] In other words, given the general deductibility of state income taxes on federal returns,[70] if a state offers a reduction in state income tax for charitable contributions (whether by credit or deduction), the reduced

67. 2011 CCA, *supra* note 10, at 4. At the time of the IRS opinion, it may have been hard to foresee an "unusual circumstance" when a substance over form analysis would be required. But that was before the TCJA made state workaround schemes in the economic self-interest of a taxpayer. *See* Walczak, *supra* note 62, at 7 (noting that if the state workaround credits "do not constitute such circumstances, it is difficult to imagine what would").

68. 2011 CCA, *supra* note 10, at 4.

69. *Id.*

70. Prior to the TCJA, there was no express limit on the itemized deduction for state and local taxes. That said, as an itemized deduction, the deduction is not available to nonitemizers. Also, before the TCJA, the SALT deduction was subject to the overall limitation on itemized deductions, known as the Pease limitation. I.R.C. § 63 (2012).

state tax liability means the loss of a SALT deduction in the same amount. Thus, in the IRS's view, it did not make sense to regard a state tax credit as a return benefit.[71]

To illustrate, assume a taxpayer who is in a 37% federal income tax bracket and has state income tax liability.[72] Also assume that the state allows a 100% income tax credit for payments to the X Fund, which is a section 501(c)(3) organization. Before the TCJA, for every $1,000 the taxpayer pays the state in taxes, the taxpayer gets a $1,000 SALT deduction, saving the taxpayer $370.[73] Thus, the after-tax cost of the $1,000 tax payment is $630. By contrast, if the taxpayer makes a $1,000 payment to the X Fund, the $1,000 reduction in state taxes from the credit

---

71. The IRS also says in another ruling (also cited by the *FDR Paper* authors), that it does not make sense to view state tax benefits as the "equivalent of a payment to the taxpayer" because the benefit "simply enters into the computation of the taxpayer's state or local tax liability and is reflected in the amount of the taxpayer's § 164 [SALT] deduction." I.R.S. Chief Couns. Adv. Mem. 201147024, n.1 (Nov. 25, 2011). The IRS makes a similar point in IRS Chief Couns. Adv. Mem. 200435001, noting that "if a charitable contribution deduction under § 170 of the Internal Revenue Code is not allowable for federal income tax purposes, it is possible that an equivalent deduction may be allowable under I.R.C. § 162 or § 164, as a payment of state tax." I.R.S. Chief Couns. Adv. Mem. 200435001 (Aug. 27, 2004).

72. The current top marginal rate is 37 percent. Before the TCJA, the top marginal rate was 39.6 percent. TCJA, Pub. L. No. 115-97, § 11001, 131 Stat. 2054, 2054–59 (2017) (codified as amended in scattered sections of 26 U.S.C.); *Historical Highest Marginal Income Tax Rates*, TAX POL'Y CTR. (Mar. 22, 2017), https://www.taxpolicycenter.org/statistics/historical-highest-marginal-income-tax-rates.

73. The examples also assume the taxpayer does not owe AMT. Because state taxes are not deductible for AMT purposes but charitable contributions are, it has been possible to derive a profit from the combined value of state tax credits and the federal charitable deduction. This was an arguable misuse of the charitable deduction under prior law and has been described as a questionable tax shelter. *See* PUDELSKI & DAVIS, *supra* note 14, at 3–4 (relaying several different tax shelter promotions such as: "If you are a taxpayer stuck in . . . AMT, this charitable contribution can make you money!"; "you can make money by donating"; "you will end with more money than when you started"). To the extent the full deduction rule was used to validate profit-taking via the charitable deduction for AMT taxpayers, it was applied beyond the confines of the CCA, the legal baseline for which was deductible state taxes.

also means a reduced SALT deduction of $1,000. In other words, the taxpayer stands to lose the value of the SALT deduction ($370) by making the payment to charity. Thus, if the taxpayer makes the payment to charity, and it is not deductible as a charitable contribution, the after-tax cost to the taxpayer is $1,000, meaning that the taxpayer is worse off than if the taxpayer had made the payment directly to the state.

Under these circumstances, the IRS viewed the state tax credit as a detriment not a benefit. Although the taxpayer receives a dollar for dollar return for the contribution in terms of reduced tax liability, because of the loss of the SALT deduction, the return does not benefit the taxpayer apart from the intangible and incidental benefit of allocating tax dollars to a particular cause. Thus, rightly or wrongly, by applying a full deduction rule and ignoring the state tax benefit, the IRS simply allowed the deduction (as a charitable contribution) of an otherwise deductible expense.

To take the illustration further, once a charitable deduction of the $1,000 payment to the X Fund is allowed, the value of the $1,000 deduction to the taxpayer is $370, bringing the after-tax cost of the $1,000 outlay back to $630. By applying a full deduction rule, instead of paying $370 as a SALT deduction, the federal government pays $370 as a charitable deduction.[74] The state has the same spending power ($1,000, through the charity). The federal government makes the same contribution ($370). The taxpayer's total outlay in either case is $1,000, the after-tax cost of which is $670. Allowing the charitable deduction for the state tax benefit does not benefit the taxpayer who is in the same position after taxes as if the taxpayer paid the state directly.

---

74. All the State achieves with the 100% credit is to direct the taxpayer's payment toward a particular cause sanctioned by the State.

The same analysis applies to less lucrative state tax benefits, whether in the form of a credit or a deduction. For example, assume that a state offers either a 10% credit or a deduction for contributions to a section 501(c)(3) organization. Also assume that the state income tax is a flat rate of 10% and again that the taxpayer is in a 37% federal income tax bracket. If the taxpayer makes a $1,000 payment to a 501(c)(3) organization, pursuant to either the credit or the deduction, the payment reduces state taxes by $100. The reduction in state taxes also means the loss of a $100 SALT deduction. As before, even though the value of the tax benefit is much less ($100), the tax benefit is still a detriment to the taxpayer for federal tax purposes because of the related loss of a $100 SALT deduction (a $37 value). For the IRS to allow the $100 tax benefit to be deducted as a charitable contribution under the full deduction rule again is simply to allow the taxpayer to recover what would otherwise be a deductible amount.

Critically, therefore, when the IRS articulated the full deduction rule, the context was the pre TCJA legal baseline: the federal deductibility of state and local tax payments. The full deduction rule was the mechanism for allowing the deduction of an otherwise deductible amount. Put another way, the full deduction rule was a means of implementing the policy of the SALT deduction rather than the policy of the charitable deduction. By limiting the SALT deduction, however, the TCJA undercuts the reasoning that supported the full deduction rule, i.e., the loss of the SALT deduction due to the contribution. Thus, the TCJA has opened the door for the Treasury Department and the courts to characterize state tax benefits as an external feature that should be considered in determining whether there is a contribution.

2. Case law cited in support of the full deduction rule

In addition, the cases the IRS cited in the 2011 CCA in support of the full deduction rule do not stand for a bright line rule that receipt of tax benefits are ignored. Instead, the cases discuss the role of a tax avoidance motive in determining the donative intent of the taxpayer (i.e., the relevance of the fact that a taxpayer gives *because of* the tax benefits and not from a pure charitable impulse). The cases generally conclude that a tax avoidance motive is not controlling.

For example, in *McLennan v. United States*, the IRS argued that the taxpayers contributed a conservation easement solely for the tax benefits and other selfish reasons, and therefore the deduction should be disallowed.[75] The court disagreed, finding that, tax benefits aside, the taxpayers "believed that the imposition of a conservation easement would decrease the value of their property. Their decision to donate the easement was, therefore, not an easy one."[76] The court also said that the taxpayers "did not inquire into the tax consequences of the conveyance until after the decision to transfer the scenic easement was made" and "were [not] motivated by tax concerns in granting the scenic easement."[77] Thus, the court concluded: "Any benefit which inured to plaintiff from the conveyance was merely incidental to an important, public spirited, charitable purpose" and the taxpayers therefore had "the requisite donative intent."[78] Setting aside the court's (somewhat questionable) reliance on subjective concerns, the case stands for the proposition that when a taxpayer has given up something of value, the fact that tax benefits are part of a taxpayer's motive for giving is not controlling.

Similarly, in *Skripak v. Commissioner*, the IRS also argued that the taxpayers were motivated by tax avoidance in making charitable contributions and so should not get a

75. 24 Cl. Ct. 102, 105 (1991), *aff'd*, 994 F.2d 839 (Fed. Cir. 1993).

76. *Id.* at 106.

77. *Id.*

78. *Id.* at 107.

deduction.[79] The court, however, said that "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."[80] This statement merely confirms that subjective motive is not the test for a contribution. What mattered to the court in *Skripak* was the outcome of the taxpayer's actions, namely that they actually contributed property (books) to charity; their reason for doing so was not significant.[81] The court said, citing *Gregory v. Helvering*: "the determinative question is 'whether what was done, apart from the tax motive, was the thing which the statute intended.'"[82] Helping charity by providing books for use in charitable programs "is precisely the result intended by [the charitable deduction]."[83]

3. Summary

In sum, the full deduction rule, as embodied by the IRS's statement in the 2011 CCA that the receipt of state tax benefits "is not regarded as a return benefit that negates charitable intent, reducing or eliminating the deduction itself" is now of questionable applicability.[84] The IRS made the statement in reliance on the longstanding general rule, now changed, that state tax payments were

79. *See* 84 T.C. 285, 314 (1985).

80. *Id.* at 319.

81. *Id.* at 319–20.

82. *Id.* at 319 (quoting Gregory v. Helving, 293 U.S. 465, 469 (1935)).

83. *Id.* at 319–20. That said, the taxpayers in *Skripak* overvalued the books, and although the court found they were entitled to a charitable deduction, the amount was reduced to the actual value. *Id.* at 328–29. In addition to *McClennan* and *Skripak*, the IRS in the 2011 CCA cited Allen v. Comm'r, 92 T.C. 1 (1989), *aff'd*, 925 F.2d 348 (9th Cir. 1991). *See* 2011 CCA, *supra* note 10, at 9–10 (Feb. 4, 2011) (applying substance over form analysis to find that nothing of value was conveyed to charity and so denying a charitable deduction).

84. 2011 CCA, *supra* note 10, at 4.

federally deductible. As such, the full deduction rule was used to implement the policy of the SALT deduction. Further, the cases cited in support of the full deduction rule stand for the proposition that subjective reasons (tax benefits) for making a transfer are not determinative in deciding whether a taxpayer has made a contribution. These cases have little to no bearing on the question of whether tax benefits are relevant external features of a transaction. Accordingly, the full deduction rule does not reflect black letter law after the TCJA and should not be relied upon to decide whether tax benefits are taken into account for contribution purposes.

B. *Denying a Charitable Deduction for State Tax Benefits*

After the TCJA, state and local tax payments over $10,000 are not deductible on federal returns.[85] The issue is whether the nondeductibility of state taxes affects whether tax benefits should be taken into account as return benefits for purposes of the charitable deduction. As explained below, after the TCJA, to allow a charitable deduction for state tax benefits would run counter to the longstanding principle of charitable contribution law that a deduction should be allowed only to the extent a taxpayer makes a sacrifice. When the cost of a taxpayer's contribution is reduced by state tax benefits, the reduced cost should be reflected in the measure of the contribution for federal tax purposes. Further, the failure to take state tax benefits into account would convert the charitable deduction from an incentive to give into an incentive to profit, which would be woefully inconsistent with the purpose of the deduction.

1. State tax benefits reduce the taxpayer's cost

As explained in Part I, the essential measure of a

---

85. Pub. L. No. 115-97, § 11042, 131 Stat. 2054, 2088–87 (2017) (codified as amended in scattered sections of 26 U.S.C.).

contribution is the extent of a taxpayer's sacrifice. The standard quid pro quo analysis measures a contribution by the amount transferred less the amount received. This measure is intended to capture the amount a taxpayer has given away, i.e., the taxpayer's cost. Only this amount is, or should be, deductible. Direct and indirect benefits are included in the calculation and the benefit does not have to be provided by the charity.

State tax benefits for charitable transfers reduce the taxpayer's cost. Assume that a state provides a 100% state income tax credit for a transfer to a charity. A taxpayer makes a $1,000 payment to charity. In return, the taxpayer may reduce state income taxes by $1,000. The net cost to the taxpayer from the transfer is zero. The measure of the contribution for federal purposes should reflect the taxpayer's cost and be zero, i.e., no charitable deduction.

Assume instead that a state with a flat state income tax rate of 10% provides a 10% credit, or a deduction, for charitable transfers. A taxpayer makes a $1,000 payment to charity. Whether the incentive is the credit or the deduction, the payment entitles the taxpayer to reduce state income taxes by $100. The cost to the taxpayer from the transfer is $900. The measure of the contribution for federal purposes again should reflect the taxpayer's cost and be $900, i.e., a federal charitable deduction of $900.

In other words, under both examples, taxpayers should not be allowed a federal charitable deduction for state tax benefits. The contribution for federal purposes should reflect the amount transferred less benefits received.[86] As

86. One could argue that the measure of the contribution should take federal tax benefits into account, and further that it is inconsistent to consider state but not federal tax benefits as return benefits. The federal charitable deduction, however, is best viewed as a giving incentive, the point of which is to reduce the taxpayer's cost. The question is by how much. To the extent the taxpayer's cost is already partially subsidized by state tax benefits, there is, after the TCJA, no reason to subsidize the state subsidy with the charitable

explained in Section II.A the full deduction rule is not a barrier to this result. Further, the result is consistent with the longstanding interpretation of a contribution as reflecting a taxpayer's sacrifice or cost. The result also is consistent with the Supreme Court's approach to assessing a contribution and donative intent based on the external features of the transfer. State tax benefits are objectively determinable and not based on the taxpayer's motive.

Moreover, disallowing a deduction for state tax benefits also is consistent with either of the main theories of the charitable deduction. Under a subsidy theory, the charitable deduction is intended as an incentive to make a sacrifice.[87] State tax benefits reduce the taxpayer's sacrifice. Allowing their deduction as charity is to incentivize state tax benefits, not personal sacrifice. Further, under the less widely accepted base-defining theory, a charitable deduction is allowed only for amounts not available for the taxpayer's personal consumption.[88] State tax benefits restore income to the taxpayer for personal use, meaning that the taxpayer has an ability to pay federal tax with respect to the state tax benefit. In short, under either theory, to allow a charitable deduction for state tax benefits is to allow a deduction even though the taxpayer has not suffered a reduction in wealth.[89]

---

deduction. To reduce the amount of the federal subsidy by taking into account the value of federal tax benefits, however, would be an indirect way of reducing the cost of the federal subsidy that runs counter to the traditional measure of the contribution amount and undoubtedly would require legislation.

87. John D. Colombo, *The Marketing of Philanthropy and the Charitable Contributions Deduction: Integrating Theories for the Deduction and Tax Exemption*, 36 WAKE FOREST L. REV. 657, 682 (2001) (noting that the conventional wisdom is that charitable tax benefits subsidize the social benefits charities provide).

88. William D. Andrews, *Personal Deductions in an Ideal Income Tax,* 86 HARV. L. REV. 309, 344–76 (1972). For a discussion of the base-defining and subsidy theories and implications for tax reform, *see* Roger Colinvaux, *Rationale and Changing the Charitable Deduction*, 138 TAX NOTES 1453 (2013).

89. *See* Douglas A. Kahn & Jeffrey H. Kahn, "*Gifts, Gafts, and Gefts" – The*

2. An incentive to profit

In addition, to allow a taxpayer a charitable deduction for state tax benefits potentially is to convert the charitable deduction from an incentive to give into an incentive to profit. Doing so would be contrary to the purpose of the charitable deduction and is not required by the TCJA.

For example, assume a taxpayer that has $40,000 of now nondeductible state tax liability and who is in a 37% federal income tax bracket.[90] The state allows a state income tax reduction for payments to Fund X. If the taxpayer pays $40,000 to the state as income taxes the after-tax cost to the taxpayer is $40,000. But, if payments to Fund X are federally deductible as charitable contributions, then depending on the level of the state tax benefit it may be in the taxpayer's economic interest to make a contribution to Fund X.

First, assume that a state provides a 100% income tax credit for contributions to Fund X. The taxpayer pays $40,000 to Fund X, which (for the sake of argument) is deductible as a federal charitable contribution. In return, the taxpayer gets a $40,000 reduction in state taxes plus a federal charitable deduction worth $14,800 ($40,000 times 37%). By reason of the payment to Fund X, the taxpayer saves $14,800—a net benefit. Thus, the taxpayer will profit by making the outlay to Fund X instead of paying the state directly. In other words, if a charitable deduction for the state tax benefit is allowed, the federal government finances a windfall to the taxpayer who has made no

---

Income Tax Definition and Treatment of Private and Charitable "Gifts" and a Principled Policy Justification for the Exclusion of Gifts from Income, 78 NOTRE DAME L. REV. 441, 521 (2003) (noting that "charitable deductions are allowed only to the extent that the donor's wealth is reduced").

90. The taxpayer may have additional state tax liability that is deductible. For example, given the assumption of $40,000 of nondeductible state tax liability, the likely state tax obligation is $50,000 given that $10,000 of SALT is deductible, assuming that the taxpayer otherwise has sufficient additional itemized expenses to forego the standard deduction.

sacrifice and who in fact now profits from the transaction. Through the charitable deduction, the taxpayer finances a $40,000 liability by paying only $25,200. The $14,800 savings is kept by the taxpayer and deducted.

If the state tax benefit is less than a 100% credit, a taxpayer may still be able to profit from a charitable contribution. To take one example, assume the state provides an 80% income tax credit for contributions to Fund Y and again the taxpayer has a nondeductible state tax obligation of $40,000. The taxpayer makes a $40,000 contribution to Fund Y and gets a $32,000 reduction in state tax liability in return, thereby reducing (direct) state income tax payments to $8,000.[91] If the $40,000 is deductible as a charitable contribution on the taxpayer's federal return, the taxpayer saves $14,800 in taxes. This savings can be used to pay the remaining $8,000 of state tax liability, with another $6,800 left over for the taxpayer to keep. Thus, in order to fund a tax obligation of $40,000, the taxpayer has an outlay of $48,000 ($40,000 transfer to Fund Y and $8,000 in direct tax payments), the after-tax cost of which is $33,200.

In this example, therefore, the $40,000 in state tax liability can cost the taxpayer $40,000 if made directly to the state or $33,200 if made to Fund Y. In other words, reducing the amount of the state credit from 100% to 80% means a lower economic benefit to the taxpayer, $6,800 instead of $14,800, but in either case, the taxpayer profits from the transaction. This is little more than using the charitable deduction as a tax shelter, not as a means to promote sacrifice.

As explained in a recent paper by the Institute on Taxation & Economic Policy some taxpayers already appear

91. The $8,000 tax payment may be deductible under SALT if the taxpayer had not already used the $10,000 SALT deduction (and has sufficient other itemized expenses).

to be taking advantage of this sort of profit taking.[92] The State of Alabama offers a 100% income tax credit for certain contributions.[93] Prior to the TCJA, the take up rate with respect to the credit was low, suggesting that taxpayers had little interest in making these contributions in lieu of payments to the State's general treasury fund (which could be used for any purpose of the State).[94] However, after the TCJA's SALT limitation made state tax payments more expensive, taxpayers have an economic incentive to shift payments from the State's general fund to the State sanctioned charity, and the Alabama 100% credit program quickly reached its limit.[95] The timing of the sudden popularity of the credit program suggests taxpayers recognized the ability to profit from the charitable deduction.

3. Lack of supportive congressional intent

For the Treasury Department or the courts to construe the charitable deduction to allow a deduction for state tax benefits, and to incentivize profitable transactions in this manner, would run counter to the purpose of the deduction without any supportive congressional intent. In the words of the Supreme Court in *Hernandez*, the courts should not "expand the charitable contribution deduction . . . beyond what Congress has provided;"[96] an outcome the court was "loath to effect . . . in the absence of supportive

92. CARL DAVIS, INST. ON TAX'N & ECON. POL'Y, SALT/CHARITABLE WORKAROUND CREDITS REQUIRE A BROAD FIX, NOT A NARROW ONE: NARROW FEDERAL ACTION WOULD BE UNFAIR, ARBITRARY, AND INEFFECTIVE 2 (2018), https://itep.org/wp-content/uploads/charitableworkaround_0518.pdf.

93. *Id.* at 9–10.

94. *Id.* at 10–11 (noting that "It was not until the donations actually become profitable for a larger group of taxpayers—because of the SALT cap—that the state began easily distributing its full credit allotment.").

95. *Id.*

96. Hernandez v. Comm'r, 490 U.S. 680, 693 (1989).

congressional intent."[97]

In the TCJA, Congress expressly eliminated the deductibility of state and local tax payments above $10,000.[98] At a minimum, this illustrates Congress's intent to deny a deduction for state tax payments. As explained in Section II.A, a corollary of the change is to moot the full deduction rule, which allowed a deduction for an otherwise deductible amount. Thus, Congress changed the policy of the SALT deduction, but left alone the general principle that a charitable contribution reflects taxpayer sacrifice. There is no supportive congressional intent in the TCJA to undermine this basic principle of charitable contribution law.[99]

Further, as a general matter, there is historical precedent that Congress does not intend for tax benefits associated with the charitable deduction to generate taxpayer profit.[100] Prior to the Tax Reform Act of 1969, the combination of a fair market value-based charitable

---

97. *Id.*

98. Pub. L. No. 115-97, § 11042, 131 Stat. 2054, 2088–87 (2017) (codified as amended in scattered sections of 26 U.S.C.).

99. Others have argued that recharacterizing tax payments as charitable contributions is to take a form over substance approach contrary to congressional intent. *See* Faber *supra* note 62, at 11 (citing substance over form as the basis for disallowing the charitable deduction); Walczak, *supra* note 62, at 6 (same). Professor Amandeep Grewal provides an in depth discussion of a substance over form approach as compared to alternatives in *Ineffective SALT Substitute*, *supra* note 11 (recommending a substance over form approach). As a general matter, a substance over form approach would apply only to state credits not deductions, and does not address the broader issue of the appropriate measurement of a contribution for federal tax purposes after the TCJA.

100. Even if it was possible under prior law for taxpayers, especially AMT taxpayers, to profit from the charitable deduction, it does not follow that it was right or correct as a matter of law. By (potentially) opening the floodgates to charitable tax shelters the TCJA has called attention to a problem that already existed in the periphery. Further, by undermining the full deduction rule, the TCJA gives the Treasury Department and the courts the opportunity to protect the integrity of the charitable deduction.

deduction for appreciated property and high marginal ordinary income tax rates made it possible for a taxpayer to be better off donating rather than selling property. This result was anathema to Congress. In changing the law to reduce the amount allowed as a deduction, the Senate Finance Committee explained that the charitable deduction was not:

> intended to provide greater—or even nearly as great—tax benefits in the case of gifts of property than would be realized if the property were sold and the proceeds were retained by the taxpayer. In cases where the tax savings is so large, it is not clear how much charitable motivation actually remains. It appears that the Government, in fact, is almost the sole contributor to the charity.[101]

This excerpt shows that the Committee viewed the charitable deduction as an incentive to encourage acts of generosity. If tax benefits become too lucrative, they cloud donative intent, and Congress concluded that there should be no deduction even though the charity still received valuable property.[102]

---

101. S. REP. NO. 91-552, at 80–81 (1969). For additional discussion of the change, *see* Roger Colinvaux, *Charitable Contributions of Property: A Broken System Reimagined*, 50 HARV. J. ON LEGIS. 263 (2013). Note that the ability of taxpayers to deduct untaxed appreciation is also a windfall to donors, widely viewed as a mistake the Treasury Department made in writing regulations early in the 20th century. *Id.* at 268. The Treasury Department should not make a similar mistake now.

102. S. REP. NO. 91-552, at 80–81. The legislation reduced the amount allowed as a deduction from fair market value to the donor's cost basis (i.e., a recovery of the amount paid for the property). *Id.* One could argue that because this result required legislation, legislation should also be required today. However, the argument of this Article is that the basis for ignoring state tax benefits under prior law—the full deduction rule—was the general deductibility of state and local taxes. With the SALT limitation of the TCJA mooting the full deduction rule, regular charitable contribution principles come into play making additional legislation unnecessary. Of course Congress could amend the law specifically to allow the deduction of state and local tax benefits, but Congress has not. Furthermore, the reason legislation was required in 1969 was because the external features of a donation of property would not take into account the tax savings of not paying tax on capital gain. Whether the taxpayer would have otherwise sold the property and triggered the capital gains tax is a subjective

Thus, historically, Congress has not intended for the charitable deduction to become a windfall for the taxpayer. Construing the meaning of contribution to allow a deduction for amounts not spent, absent express congressional intent, is inconsistent with this basic goal and would expand the deduction beyond its historic confines as a giving incentive into a profitable tax shelter. The measure of a contribution is a taxpayer's sacrifice; state tax benefits received for a charitable transfer should be taken into account.

III. IMPLICATIONS AND POLICY CONCERNS

The implications of the implicit repeal of the full deduction rule and measuring a contribution by the extent of a taxpayer's sacrifice are several. Most obvious is that state efforts to avoid the cap on the SALT deduction by setting up charitable funds for taxpayers to make transfers in exchange for state tax benefits would be ineffective. More broadly affected though, would be the deductibility of other payments to section 501(c)(3) organizations that trigger state tax benefits and previously have been deductible.[103] There also would be administrative issues associated with denying a charitable deduction for state tax benefits.

A. *Nondeductibility of Previously Deductible Expenses*

As argued in this Article, the historic approach to defining a contribution as the measure of a taxpayer's sacrifice strongly suggests that no charitable deduction is allowed for state tax benefits. This analysis applies equally to existing state credits and deductions as to credits designed to avoid the SALT limit. Thus, whereas before the

---

question and not an inherent part of the transfer.

103. The *FDR Paper* provides a listing of many such state programs. *FDR Paper*, *supra* note 9, at App'x. A. *See also* DAVIS, *supra* note 92, at 11–15 (providing an overview of different state credit programs).

TCJA, a taxpayer could deduct as charity the value of a 100% tax credit; after the TCJA no deduction for the state tax benefit should be allowed.

Further, as explained below, although denying a charitable deduction for amounts that previously were deductible as charity may seem like a dramatic legal change, doing so in fact reflects the status quo of pre-TCJA law, in that under prior law, given the loss of a SALT deduction, a charitable deduction for state tax benefits was not a benefit to the taxpayer. Accordingly, to deny a charitable deduction for state tax benefits after the TCJA is a change more of form than substance.

To illustrate, consider again a state that offers a 100% income tax credit for payments to a state preferred charity.[104] Before the TCJA, as a matter of federal law it made no difference to a taxpayer whether the taxpayer made a payment to the charity or directly to the state. A full deduction for the payment was allowed in either case, whether under the SALT deduction or the full deduction rule.

For example, if a taxpayer in the 37% federal income tax bracket made a $1,000 payment, the federal subsidy would be $370 either as a SALT deduction or as a charitable deduction. The charitable deduction for the value of the state tax benefit provided no added benefit. The same was true for less valuable state tax credits or a state charitable deduction. The federal charitable deduction for the value of the state tax benefit was an offset to the loss of the SALT deduction.

After the TCJA, however, if the full deduction rule continues to be applied, the charitable deduction would now be a gain to the taxpayer. For instance, in the example

104. The Supreme Court discussed an Establishment Clause challenge to one such program in *Ariz. Christian Sch. Tuition Org. v. Winn*, 563 U.S. 125 (2011). *See also FDR Paper*, *supra* note 9, at 651–52.

above, if the taxpayer makes the $1,000 payment to the state, the federal subsidy is zero (assuming the SALT cap is otherwise met). If the taxpayer makes the payment to the state preferred charity, the federal subsidy is $370, all of which represents a profit to the taxpayer. In other words, before the TCJA, federal tax law was neutral between the two payments. Continued deductibility as charity of the state tax benefits would undermine this neutrality and spur taxpayers to make contributions to the state preferred charity, and at a potentially high cost to the federal treasury.

The authors of the *FDR Paper* cite federalism concerns as a reason to allow continued deductibility of state tax benefits. According to the *FDR Paper*, the full deduction rule "is properly neutral" toward state initiatives.[105] However, as discussed above, this was true prior to the TCJA, when the full deduction rule allowed a charitable deduction in order to foster symmetry with the SALT deduction. After the TCJA, a federally neutral approach is to deny the charitable deduction for state tax benefits; to do otherwise is to directly subsidize the provision of state tax benefits, which is not neutral. In addition, states would remain free to offer incentives that reduce the cost of the transaction and a federal deduction would still be available with respect to the payment unless the state fully reimbursed the taxpayer's cost.

In short, the critical point is that not to allow a charitable deduction for state tax benefits after the TCJA is in fact to remain faithful to the status quo prior to the TCJA. The status quo was that taxpayers derived no benefit from the charitable deduction.[106] To apply the full deduction rule after the TCJA would be to provide a new benefit, to

105. *FDR Paper*, *supra* note 9, at 654.

106. As discussed, *supra* notes 73 and 100, AMT taxpayers did derive a benefit.

define charity in a new way that does not require sacrifice, and to allow a deduction for kept amounts.

B. *Administrative Issues*

Disallowing a charitable deduction for state tax benefits will have administrative implications. A detailed discussion of administrative issues is beyond the scope of this Article.[107] As a general matter, however, because taxpayers would have to reduce the amount claimed as a federal charitable deduction by the value of any state tax benefits received, the amount of the state tax benefit for charitable transfers would have to be determined as a routine part of federal tax preparation.

If the state tax benefit is a credit, in general, the value of the tax benefit is the amount paid times a set percentage. As the *FDR Paper* authors detail, charitable tax credits may have a number of complicating features, including caps, filing status limits, varying credit percentages, priority rules, and carryforwards.[108] These features attest to the complexity of the particular state credit at issue, but nonetheless, the amount, even if complex to calculate, must be determined by the taxpayer in any event and so can be accounted for on the federal return.

If the state tax benefit takes the form of a deduction, the value of the tax benefit depends on the state marginal

107. The authors of the *FDR Paper* wrote a second paper that focused on administrative problems with limiting the full deduction rule. *Caveat IRS*, *supra* note 46. Many of the problems they identify relate to possible changes to the full deduction rule that are not suggested in this Article. For example, they consider the implications of applying the full deduction rule to some charities but not others and the potential difficulties of measuring the contribution when both federal and state tax benefits are taken into account. *Id.* at 550–556. Neither approach is suggested here, thus the authors' concerns about arbitrariness and circularity, which make up the bulk of the paper, are of less relevance. The *FDR Paper* also argues that eliminating the full deduction rule would present "administrative difficulties." *FDR Paper*, *supra* note 9, at 654.

108. *Caveat IRS*, *supra* note 46, at 552.

rate of the taxpayer. In states with one income tax rate, the value of the benefit is straightforward (the amount paid times the rate). In states where the value of the benefit depends upon knowing the marginal rate of the taxpayer, the calculation is more complex, yet still is a calculation already required for purposes of the state return. The challenge, as with a credit, is accounting for the value of the state tax benefit on the federal return.

The principal administrative challenges thus likely relate to timing issues. These would arise if the taxpayer files the federal return before the state return. In such cases, the taxpayer would have to determine for the federal return the value of state tax benefits prior to filing the state return. This is made more complex for states that base state taxable income on federal taxable income, which as the *FDR Paper* authors point out, "depends on the amount of the federal deduction allowed."[109] In addition, if a state denies the claimed benefit, or the taxpayer subsequently does not claim the state tax benefit, the taxpayer in theory should be allowed to increase the claimed amount of the federal charitable deduction through an amended return.

One possible solution to these concerns, proffered by the *FDR Paper* authors, would be to delay the accounting for state tax benefits to the year following the contribution year.[110] In the year of contribution, the taxpayer would take a federal charitable deduction that included the value of the state tax benefit. The following year, the taxpayer would include as income the value of the state tax benefit. This is a similar approach to accounting for state tax refunds (and

109. *Id.* at 551. Professor Grewal notes that "only 6 states use federal taxable income as the starting point to compute state taxable income;" Most states use adjusted gross income. Grewal, *Ineffective SALT Substitute*, *supra* note 11, at 25, n.124. Further, as Grewal suggests, to the extent circularity problems arise, "that would reflect a problem appropriately addressed by changing the state tax system, not by twisting Section 170." *Id.*, n.123.

110. *Caveat IRS*, supra note 46, at 553.

other state payments) on federal returns.[111] This is not to suggest that such an approach is necessarily the best or would address all issues, but rather to note that administrative solutions could and would be developed.[112]

In short, although denying a federal charitable deduction for the value of state tax benefits would introduce additional complexity to tax administration, complexity is a mainstay of the federal tax system and often necessary as a matter of law and to implement sound policy. The policy here is to maintain the charitable deduction as an incentive to give not to profit. To subsidize amounts not spent is not the purpose of the charitable deduction, nor is such an expansion of the charitable deduction legally required by the TCJA. Potential administrative concerns should not be decisive in construing the meaning of a contribution for federal tax purposes.

IV. CONCLUSION

Before the Tax Cuts and Jobs Act, state tax benefits could be deducted as charitable contributions pursuant to a full deduction rule. The IRS conceived the full deduction rule against a legal baseline of deductible state tax payments. The essence of the rule was to allow as a charitable contribution the deduction of an otherwise deductible expense. As such, the full deduction rule was an instrument of the SALT deduction not the charitable deduction and did not make taxpayers better off.

The TCJA fundamentally changed the law by substantially limiting the deductibility of state and local tax payments. One corollary of the change is to undermine the

111. *See* IRS Form 1099-G: Certain Government Payments.

112. As a general matter, as Professor Grewal argues, "[i]ntertwined tax systems no doubt present compliance questions, but we now have years of principles and practices to help answer them." Grewal, *Ineffective SALT Substitute*, *supra* note 11, at 26.

full deduction rule, leaving open the question of how to account for state tax benefits for purposes of the charitable deduction.

Under established principles, a charitable contribution is measured by the taxpayer's sacrifice. If the cost of a taxpayer's payment to charity is reduced by state tax benefits, the taxpayer's sacrifice is reduced. Accordingly, a contribution for federal tax purposes should take into account the value of state tax benefits received.

Continued application of the full deduction rule is not warranted and would convert the charitable deduction from an incentive to give into an incentive to profit. Allowing a deduction for state tax benefits would be to allow taxpayers to deduct amounts not spent and that are available for the taxpayer's use. This result is anathema to the fundamental idea of an incentive for giving and for selfless behavior. The result applies equally to credits devised as workarounds to the SALT deduction as to other state credits and deductions. States remain free to provide tax benefits for transfers to charity, but the value of the tax benefits received should not be considered part of the contribution for federal tax purposes.

The issue going forward for the Treasury Department and the courts is stark: to allow the charitable deduction to become a tax shelter, or to preserve the historic nature of the deduction as an incentive for selfless behavior.