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THE CHARITABLE CONTRIBUTION STRATEGY: AN INEFFECTIVE SALT SUBSTITUTE

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I. INTRODUCTION

The Tax Cuts and Jobs Act (TCJA) has provoked significant controversy, especially for a revenue bill.¹ Though politicians and experts often spar fiercely over tax policy, the TCJA drew passionate new voices into the debate, with some citizens even taking their concerns to the streets.² The close association between the TCJA and the controversial President no doubt added fuel to the fire.

Although the TCJA will, on net, immediately reduce taxes for all income groups and for taxpayers across the United States,³ some believe that it unfairly targets specific states.⁴ In particular, the new \$10,000 limit on

¹ An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

² See Adam Gabbatt, *The Resistance Now: activists plan to protest the Republican tax bill*, THE GUARDIAN (Nov. 18, 2017), <https://www.theguardian.com/us-news/2017/nov/18/the-resistance-now-activists-plan-to-protest-the-republican-tax-bill>; David Weigel, *Protesters storm Congress to fight tax bill, as cameras point elsewhere*, THE WASH. POST (Dec. 18, 2017), https://www.washingtonpost.com/news/powerpost/wp/2017/12/18/protesters-storm-congress-to-fight-tax-bill-as-cameras-point-elsewhere/?noredirect=on&utm_term=.334b7ed2010c.

³ See Frank Sammartino, Philip Stallworth, & David Weiner, *The Effect of the TCJA Individual Income Tax Provisions Across Income Groups and Across the States*, TAX POL'Y CTR., 2, 14 Table A1, Mar. 28, 2018, http://www.taxpolicycenter.org/sites/default/files/publication/154006/the_effect_of_the_tcja_individual_income_tax_provisions_across_income_groups_and_across_the_states.pdf. (noting that “[t]axes will decline on average across all income groups” and also detailing state-by-state tax cuts).

⁴ See, e.g., Michael C. Dorf, *The New Tax Law Punishes Blue States: Is That Constitutional?*, VERDICT (Dec. 27, 2017) (“In shifting some of the nation’s tax burden from over-represented red states to under-represented blue ones, congressional Republicans and President Trump acted in a crassly partisan manner and betrayed core ideals of a country that gained its independence by fighting a war against taxation without representation.”), <https://verdict.justia.com/2017/12/27/new-tax-law-punishes-blue-states-constitutional>. Though all states will, on net, enjoy tax cuts, some high-tax states will enjoy smaller percentage cuts than other states. See Sammartino et al., *supra* note 3, at 5 (after-tax income in New York, California, and Oregon will increase by less than 1.5%, compared to national average of 1.8%). These states disproportionately enjoyed benefits under section 164 and thus bear more of the burdens associated with its new limit. See JARED WALCZAK, TAX FOUND., THE STATE AND LOCAL TAX DEDUCTION: A PRIMER 1 (2017) (“The deduction favors high-income, high-tax

the section 164⁵ deduction for state and local taxes (or simply “state taxes”)⁶ has drawn heavy criticism from public officials in traditionally Democratic states.⁷ Because those states generally impose high taxes and offer broad government services, their residents will face the new limit more often than residents of low tax, low services states. Several high-tax states have consequently alleged that the new statutory limit arose from improper political animus. They have also filed a constitutional challenge to the TCJA.⁸

The high-tax states, however, have not left matters solely to the courts. Several have enacted workarounds that, if effective, would allow their residents to avoid the section 164 deduction limit.⁹ These workarounds generally permit nominal donations to state-controlled funds in exchange for state tax credits.¹⁰ Credits received this way may then be applied against a resident’s tax liability. If this strategy works, nondeductible state tax payments will have been transformed into fully deductible charitable contributions.¹¹

states like California and New York, which together receive nearly one-third of the deduction’s total value nationwide.”).

⁵ Unless the context indicates otherwise, section references are to the Internal Revenue Code of 1986 (the tax code), as amended, and as in effect for the relevant taxable year at issue.

⁶ Section 164(b)(2) provides that a state or local tax includes a tax “imposed by a State, a possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia.”

⁷ See Olivia Beavers, *Cuomo: GOP tax bill an act of ‘economic civil war’*, THE HILL, Dec. 17, 2017 (“Cuomo argued that New York and other Democratic states will be paying a higher level of taxes because the Republican tax bill plans to eliminate ‘the deductibility for state and local taxes.’”).

⁸ See Katie Lobosco, *New York and three other states claim Trump tax law is unconstitutional*, CNN, July 18, 2018, <https://www.cnn.com/2018/07/17/politics/new-york-tax-lawsuit/index.html>; New York et al. v. Mnuchin, No. 1:18-CV-06427 (S.D.N.Y. filed July 17, 2018).

⁹ See Steven M. Rosenthal, *IRS Warns States to Slow Down on Charitable SALT Workarounds*, TAX POL’Y CTR., May 24, 2018, <https://www.taxpolicycenter.org/taxvox/irs-warns-states-slow-down-charitable-salt-workarounds> (noting that Connecticut, Oregon, New Jersey, and New York have each passed versions of the charitable contribution strategy).

¹⁰ As used here, “state-controlled fund” will refer to any fund or entity that would be treated as an integral part of a state or one of its political subdivisions under I.R.C. § 164(b)(2). *See also infra* note 170.

¹¹ *See* I.R.C. § 170(a) (establishing a federal income tax deduction for charitable contributions), (c)(1) (contributions to states and their subdivisions qualify as charitable contributions, when made for exclusively public purposes). Deductions under section 170 face some limitations, and are not available for taxpayers who do not itemize. *See* I.R.C. § 170(b)(4) (treating the section 170 deduction as an item-

This article examines whether the charitable contribution strategy allows taxpayers to convert their nondeductible tax payments into deductible donations and concludes that it does not. Part I describes the charitable contribution strategy and its basic variants. Part II examines potential Internal Revenue Service (Service) arguments against the strategy and ultimately concludes that, under a substance over form analysis, nominal donations to state-controlled funds should be treated as the payment of state taxes. In other words, swapping a state tax payment for a nominal donation does not take a transaction out of section 164. Part III turns to potential regulatory responses. It examines a recent Service Notice that promises regulations on the charitable contribution strategy, and it explores different approaches that the Service might take.¹² It concludes that the Service should adopt a substance over form approach because it avoids complications that arise under other approaches. Part III also rejects calls for the Service to bless or leave alone the charitable contribution strategy.

II. THE CHARITABLE CONTRIBUTION STRATEGY

Section 164(a) allows a federal income tax deduction (the SALT deduction) for various taxes paid to a state or local government.¹³ Although the tax code usually denies deductions for personal expenses,¹⁴ section 164 historically allowed taxpayers a deduction for state taxes even when those taxes arose from non-business or non-investment activities.¹⁵ For example, a taxpayer who paid state property taxes on her principal residence could

ized deduction); I.R.C. § 63(b) (effectively denying itemized deductions to persons who take the standard deduction). However, taxpayers participating in the charitable contribution strategy generally would not face limits on their section 170 deductions and so, for ease of exposition, this article will usually assume that they are unlimited.

¹² See I.R.S. Notice 2018-54, 2018-24 I.R.B. 750. At least one state attorney general has threatened a lawsuit if the Internal Revenue Service (Service) denies the federal tax benefits claimed under the charitable contribution strategy. See Letter from Gurbir S. Grewal, N.J. Att'y Gen., to David J. Kautter, Commissioner of the I.R.S. (May 24, 2018) ("Should the IRS and Treasury Department continue down this path [suggested by Notice 2018-54], New Jersey will have no choice but to challenge the new rule in court.").

¹³ Though section 164(a) offers a deduction for taxes "paid or accrued," this article will, for ease of exposition, assume that taxpayers are on the cash method and take state taxes into account only upon payment. See Treas. Reg. § 1.461-1(a)(1) (2017) (describing standards for applying the cash method to deductions). This article will also assume that taxpayers are individuals, because non-individual taxpayers do not face the SALT deduction limit. See I.R.C. § 164(b)(6).

¹⁴ See I.R.C. § 262(a).

¹⁵ See I.R.C. § 164(a).

fully deduct that payment, even if she conducted no business or investment activities there.

The TCJA altered this framework. Under section 164(b)(6), an individual's deduction for state taxes faces an aggregate \$10,000 limit¹⁶ unless the taxes relate to business or investment activities.¹⁷ As a practical matter, this means that many wealthy or upper-income taxpayers cannot fully deduct their state taxes. For example, in some places, the average property tax bill nears or exceeds \$10,000,¹⁸ and taxpayers may hit the SALT deduction limit before even considering their state income tax payments. Thus, viewed in isolation, the new SALT deduction substantially increases federal tax liabilities in high tax states.¹⁹

Unsurprisingly, government officials in those states have fiercely attacked the SALT deduction limit. New York Governor Andrew Cuomo, for example, announced that the new limit triggered an "economic civil war."²⁰ New Jersey Governor Phil Murphy said that the limit threw a "gut punch" at his state's residents.²¹

This rhetoric has translated into action. Several states have now passed or proposed laws that purportedly allow their residents to avoid the SALT

¹⁶ This \$10,000 limit applies on an aggregate basis to the real property, personal property, and income taxes described in section 164(a)(1)-(3). See I.R.C. § 164(b)(6)(B). If the taxpayer elects to deduct state sales taxes rather than state income taxes, an aggregate approach continues to apply. *See id.*

¹⁷ Under the flush language to section 164(b)(6), state personal property and real property taxes described in section 164(a)(1) and (2) will not be subject to the \$10,000 limit when they relate to a trade or business or to activities described in section 212. See I.R.C. § 164(b)(6). State income taxes, however, face the limit regardless of the activity to which they relate.

¹⁸ See Morgan Scarboro, *Which Places Pay the Most in Property Taxes?*, TAX FOUND., May 18, 2017; Samantha Sharf, *Where In Your State Homeowners Pay The Highest And Lowest Property Taxes*, FORBES, May 1, 2017 ("In some places the annual median [real property taxes] topped \$10,000.").

¹⁹ See N.Y. ST. DEP'T OF TAX'N AND FIN., PRELIMINARY REP. ON THE FED. TAX CUTS AND JOBS ACT (2018) ("Absent changes to New York's tax code, the [TCJA's] limitations on the deductibility of state and local taxes will cost New York's taxpayers an additional \$14.3 billion per year."). Although New York loses through the SALT deduction limit, the TCJA, as a whole, reduces the aggregate tax liabilities of New York residents. *See Sammartino et al., supra* note 3, at Table A1.

²⁰ See Marissa Schultz, *GOP tax plan is a 'dagger at the economic heart of New York'*: Cuomo, N.Y. POST, Dec. 17, 2017.

²¹ See Michael Catalini, *Murphy Seeks Bill to Blunt Impact of Federal Tax Law*, ASSOCIATED PRESS, Feb. 8, 2018 (Murphy described the "dual problems of not only high property taxes but with limited ability to deduct them from federal taxes" as a "gut punch from Congress.").

deduction limit.²² Though their methods differ, this article will describe three general legislative approaches.²³ To avoid the SALT deduction limit, a state might enact legislation under (1) a full credit model, (2) a partial credit model, or (3) a private credit model.

Under the full credit model, a state offers a dollar-for-dollar, nonrefundable tax credit for any amounts that a taxpayer donates to a state-operated charitable fund. No state has enacted legislation under this model, although California once proposed a version of it.²⁴ Under the California proposal, taxpayers would receive a full tax credit for any amounts nominally donated to a special fund within the state's treasury. The state would use the donations for exclusively public purposes, as defined through the federal tax code.

In terms of cash flow, the California charitable contribution strategy creates a wash. A resident who owed, for example, \$100,000 in state income taxes would have simply replaced that payment with a donation. But if the charitable contribution strategy works, the resident will have obtained a federal tax benefit. The \$100,000 would be fully deductible as a charitable contribution under section 170 and would avoid the SALT deduction limit. If the taxpayer were in a 35% federal tax bracket, she would thus enjoy \$135,000 of financial benefits from her \$100,000 donation. That is, on her state tax return, she would enjoy a \$100,000 credit, and on her federal return, she would enjoy a deduction that reduces her federal tax liability by \$35,000.²⁵

The charitable contribution strategy may also lead to further benefits. Though the Alternative Minimum Tax sometimes claws back the benefits associated with SALT deductions,²⁶ that claw back does not apply to sec-

²² See Rosenthal, *supra* note 9.

²³ States have considered additional methods to avoid the SALT deduction limit, including changes to their payroll tax regimes. Section 164(b)(6) does not affect the deduction for state and local taxes paid by businesses, so shifting statutory payroll taxes from employees to employers would, on net, mean greater federal deductibility for state tax payments. For further discussion, see Daniel Hemel, *Implementing a State-Level Payroll Tax in Response to the Rollback of SALT*, MEDIUM, Dec. 28, 2017.

²⁴ See 2017 Cal. S.B. 227 (Cal. 2017), § 1(a) (allowing a credit "equal to the amount contributed by the taxpayer for the taxable year to the California Excellence Fund"). California Senate Bill 227 now contemplates an 85% credit for amounts contributed to a state-controlled educational fund. See 2017 Cal. S.B. 227 (Cal. 2017), § 3.

²⁵ The actual federal tax benefit would depend not only on the taxpayer's particular rate bracket but also on other factors that do not affect the principle illustrated here.

²⁶ See I.R.C. § 56(b)(1)(A).

tion 170 deductions.²⁷ And if a taxpayer converts all her state income payments into charitable contributions, she can then deduct her state sales taxes through the section 164(b)(5) election. Congress did not want taxpayers to deduct both state income taxes and state sales taxes, but the charitable contribution strategy potentially lets taxpayers get around the statutory restrictions.²⁸

The partial credit model generally follows the full credit model, but it is somewhat less generous. For example, New York's new law grants taxpayers an 85% nonrefundable income tax credit for amounts contributed to state-operated education and health care funds.²⁹ Though a partial tax credit model might seem financially unattractive to taxpayers—why pay \$100,000 to get an \$85,000 credit? —if the charitable contribution strategy works, taxpayers will receive tax benefits that exceed their contributions. The state tax benefit may be limited to \$85,000,³⁰ but the taxpayer will deduct the \$100,000 contribution against her federal gross income and enjoy a \$35,000 reduction in her federal tax liability. Thus, the taxpayer donates \$100,000 and receives \$120,000 worth of tax benefits. The further benefits related to the Alternative Minimum Tax and sales tax deductions may also apply.

²⁷ See Philip Blackman & Kirk J. Stark, *Capturing Federal Dollars with State Charitable Tax Credits*, 139 TAX NOTES 53, 54–57 (2013) (describing statutory framework related to section 164 deductions, section 170 deductions, and the Alternative Minimum Tax, and detailing benefits associated with reclassifying tax payments as charitable contributions).

²⁸ See I.R.C. § 164(b)(5) (offering an election to deduct state and local sales taxes in lieu of state and local income taxes). The state sales taxes would be aggregated with the state taxes on real and personal property, and a \$10,000 deduction limit would apply. However, if a taxpayer also pursues the charitable contribution strategy for property tax payments, she could expand her deduction for the state sales taxes.

²⁹ See Frank Sammartino, *How New York State Responded to The SALT Deduction Limit*, TAX POL'Y CTR., May 14, 2018, (describing New York's new 85-percent state tax credit for donations to state-controlled fund, and the state's authorization for subdivisions to establish funds offering up to 95-percent property tax credits); N.Y. TAX LAW § 606(iii)(1) (McKinney 2018); N.Y. GEN MUN. LAW § 6-t to 6-u (McKinney 2018); N.Y. REAL PROP. TAX LAW § 980-a(a) (McKinney 2018).

³⁰ Under the New York legislation, the donation to the state-operated fund would also entitle the taxpayer to a deduction against his state gross income. Complications related to state law deductibility are ignored here because they do not affect the principle illustrated. See St. of N.Y. Div. of the Budget, *Governor Cuomo Announces Highlights of the FY 2019 State Budget*, (Mar. 30, 2018), <https://www.budget.ny.gov/pubs/press/2018/pr-enactfy19.html> (“Taxpayers who itemize deductions may claim these charitable contributions [to the state-operated fund] as deductions on their Federal and State tax returns. Any taxpayer making a donation may also claim a State tax credit equal to 85 percent of the donation amount for the tax year after the donation is made.”).

Under the partial credit model, the state also benefits because it receives \$100,000 in exchange for only \$85,000 of credits. The partial credit model thus allows the state and the taxpayer to split the benefits associated with converting nondeductible taxes into deductible contributions. Only the federal government loses.

The full credit and partial credit models each provide tax credits for donations made to state-controlled funds, but the private credit model grants tax credits for donations to other organizations. Many states have established programs like this, although the offered credits are often small and face substantial limitations. For example, Michigan once offered a 50% tax credit for vehicles donated to some non-profit organizations, but any credits were nonrefundable and, for individual filers, could not exceed \$50.³¹ Other states, like Arizona, have enacted private credit programs with high aggregate caps.³²

In theory, a state could use the private credit model to help its residents avoid the SALT deduction limit. That is, generous credits for donations to private charities potentially let a taxpayer convert nondeductible state tax payments into deductible section 170 contributions. However, by granting such credits, a state sacrifices its own revenue needs, and states that pursue the private credit model will generally do so for reasons unconnected to federal tax avoidance. Thus, the phrase “charitable contribution strategy,” as used throughout the remainder of the article, will refer to only the full credit and partial credit models. The private credit model will become relevant later, when discussing policy objections to potential Service rulemaking.³³

III. TREATMENT UNDER EXISTING LAW

Though states have offered tax credits for some time, the case law related to their federal tax treatment remains sparse. The Tax Court has meaningfully addressed their issues only twice,³⁴ and the relevant judicial authorities do not present a consistent theoretical framework. Thus, the charitable contribution strategy presents some novel federal tax issues.

³¹ See Mich. Comp. Laws Ann. § 206.269, repealed by P.A.2011, No. 38, § 1.

³² See Howard Fischer, *In Arizona, tuition tax credit cap faces party-line stalemate*, ARIZ. DAILY SUN, Mar. 1, 2018 (discussing political controversy related to ever-increasing caps).

³³ See *infra* Part III.

³⁴ See Maines v. Commissioner, 144 T.C. 123 (2015); Tempel v. Commissioner, 136 T.C. 341 (2011) (subsequent history omitted).

But there are at least three potential Service challenges to the charitable contribution strategy that fit within existing legal principles. Under one challenge, the Service could argue that when a taxpayer obtains a tax credit in exchange for a donation, that credit reflects a *quid pro quo* that partially or wholly disqualifies the taxpayer's enjoyment of section 170 deductions. Under a second challenge, the Service could argue that a taxpayer recognizes income on the receipt of a state tax credit. The resulting income inclusion, coupled with the SALT deduction limit, would severely limit the benefits of the charitable contribution strategy. And under the third challenge, the Service can argue that a taxpayer's creditable donation to a state-controlled fund reflects, in substance, the payment of taxes. This would mean that section 164 and its strict limit, not section 170 and its looser limits, apply to the nominal donation.

This Part examines the three potential Service challenges. It shows that though the first challenge enjoys some appeal, it is uncertain whether state tax benefits can limit the deduction otherwise available under section 170. The second challenge enjoys theoretical support, but the existing case law generally excludes the receipt of a nonrefundable state tax credit from gross income. The third challenge presents the strongest line of analysis, and the Service or a reviewing court should conclude that donations under the charitable contribution strategy are directly or indirectly tax payments subject to the SALT deduction limit.

A. *Quid Pro Quo?*

For a charitable contribution strategy to work, a taxpayer's donation to the state-controlled fund must establish her right to a federal tax deduction under section 170. That section generally allows deductions for a donation made to a state when that donation is "made for exclusively public purposes."³⁵ Also, for any donation to qualify under section 170, the taxpayer must show that she intended to make a payment that exceeds the fair market value of any goods or services received in exchange – "[t]he *sine qua non* of a charitable contribution is a transfer of money or property without adequate consideration."³⁶ Even when the taxpayer displays that intention, the otherwise deductible amount must be reduced by any goods or services received.³⁷

Arguably, when a taxpayer donates to a state-controlled fund and receives state tax credits, any otherwise deductible amount must be reduced

³⁵ I.R.C. § 170(c)(1).

³⁶ *United States v. Am. Bar Endowment*, 477 U.S. 105, 118 (1986).

³⁷ See Treas. Reg. § 1.170A-1(h)(2) (2018).

by the fair market value of those credits. The regulations define “goods or services” broadly and the phrase includes, among other things, “benefits and privileges.”³⁸ That definition would seemingly reach state tax credits derived through the charitable contribution strategy. And if it does, the charitable contribution strategy will not work. A nondeductible state tax payment will merely have been converted into a nondeductible donation.³⁹

However, through a 2011 Chief Counsel Advisory, a non-precedential internal memorandum,⁴⁰ the Service expressed doubt that state tax credits reduce the section 170 deduction.⁴¹ In doing so, the Service announced that principles relating to state or federal tax deductions should extend to state tax credits. That is, prior authorities generally showed that state and federal tax deductions were ignored when measuring a “contribution or gift” under section 170. The memo concluded that the same principle should extend to state tax credits, whether received through donations to state-controlled funds or private charities.

The memo also acknowledged an important tradeoff. Though state tax credits might not reduce the section 170 deduction, they would reduce the taxpayer’s “deduction for the payment of state or local tax.”⁴² Also the memo warned that in “unusual circumstances,” a payment that generated a state tax credit could be treated as a “satisfaction of a tax liability” under section 164 rather than a charitable contribution under section 170.⁴³

³⁸ Treas. Reg. § 1.170A-13(f)(5) (2018) (punctuation altered). That definition applies through a cross-reference. See Treas. Reg. § 1.170A-1(h)(2) (2018).

³⁹ Under this approach, if a taxpayer, in place of \$100,000 tax payments, made a \$100,000 donation to a state-controlled fund and received \$100,000 in state tax credits for that donation, his section 170 deduction would be zero.

⁴⁰ See I.R.C. § 6110(k)(3) (“Unless the Secretary otherwise establishes by regulations, a written determination may not be used or cited as precedent.”), (b)(1)(A) (“written determination” includes Chief Counsel advice). Chief Counsel advice can, of course, help a taxpayer learn how an attorney for the Service might view an issue. And courts can follow Chief Counsel advice if they find their underlying reasoning persuasive. But, “[a]t bottom,” Chief Counsel advice constitutes “an internal IRS memorandum prepared by an individual IRS attorney.” *Voss v. Commissioner*, 796 F.3d 1051, 1067 (9th Cir. 2015).

⁴¹ I.R.S. CCA 201105010 (Feb. 4, 2011).

⁴² *Id.* See also Roger Colinvaux, *Failed Charity: Taking State Tax Benefits into Account for Purposes of the Charitable Deduction*, 66 BUFF L. REV. 779 (2018) (arguing that the new SALT deduction limit fundamentally alters whether and how section 170 takes into account state tax credits and deductions).

⁴³ *Id.* See also I.R.S. CCA 200435001 (Aug. 27, 2004) (nominal donations to a state that fails to qualify under section 170 arguably “should be viewed as a payment of state tax”); I.R.S. CCA 200238041 (Sept. 20, 2002) (if a state tax credit defeats a deduction under section 170, there remain issues over whether the taxpayer is entitled “to an equivalent deduction for a deemed payment of state tax” under

Many commentators believe that the 2011 memo clearly validates the charitable contribution strategy.⁴⁴ These commentators broadly assert that, under the memo and the authorities it cites, state tax benefits are simply ignored under section 170.⁴⁵ Consequently, taxpayers who donate to state-controlled funds should enjoy section 170 deductions equal to their nominal donations, even if they receive substantial state tax credits in return.

But that reliance on the 2011 memo seems misplaced. By law, that memo may not be cited as precedent.⁴⁶ And it has no greater authority than other Service memos, including those that express concerns over whether state tax credits negate a taxpayer's charitable intent.⁴⁷ Additionally, the 2011 memo acknowledges that the federal taxation of state tax credits may be best addressed through official guidance⁴⁸ and that its conclusion may

sections 162 or 164); I.R.S. Coordinated Issue Paper, State and Local Location Tax Incentives, LMSB-04-0408-023, 2008 WL 2158109, at *3 (May 23, 2008) ("In certain circumstances, where a tax benefit is received in return for the provision of specific consideration in the form of services, property, or the use of property, it may be appropriate to view the taxpayer as having, in effect, satisfied the unreduced tax liability by a payment in kind.").

⁴⁴ See Joseph Bankman, David Gamage, Jacob Goldin, Daniel Hemel, Darien Shanske, Kirk J. Stark, Dennis J. Ventry Jr., & Manoj Viswanathan, *State Responses to Federal Tax Reform: Charitable Tax Credits*, 88 ST. TAX NOTES 433, 644 (2018); David Gamage, *Charitable Contributions in Lieu of SALT Deductions*, 87 ST. TAX NOTES 973, 973 (2018) ("Do those [charitable contribution] plans work under federal law? The answer is clearly yes, at least in the sense that existing legal authorities overwhelmingly support them working."). But see Peter L. Faber, *Do Charitable Contributions Avoid the TCJA SALT Deduction Limit?*, 81 ST. TAX NOTES, 309, 310 (2018) (discounting relevance of authorities cited in the 2011 Service memo and arguing that additional cases cited by Bankman et al. are "equally unpersuasive," because they "clearly did not involve wholesale replacements of state income taxes").

⁴⁵ See Bankman et al., *supra* note 44.

⁴⁶ See I.R.C. § 6110(k)(3).

⁴⁷ See I.R.S. CCA 200435001 (Aug. 27, 2004) ("[A] payment for which a benefit of receiving a state income tax credit may be expected raises serious concerns as to the deductibility of such a payment as a charitable contribution on the contributor's federal income tax return."); I.R.S. CCA 200238041 (Sept. 20, 2002) (a "major issue" is "whether, to the extent a taxpayer is effectively reimbursed" for a donation "through the use, refund, or transfer of the credit, that benefit is a quid pro quo that reduces or eliminates a charitable contribution deduction [under section 170]"; case law requires "that the taxpayer knowingly contributed [property] in excess of the value of the state credit received in return").

⁴⁸ See I.R.S. CCA 201105010 (Oct. 27, 2010) (noting that in two prior circumstances, the office had avoided resolving state tax credit issues, suggesting that they "could be addressed in official published guidance," but providing an opinion here because "published guidance . . . is not contemplated"). See also I.R.S. CCA 200435001 (Aug. 27, 2004) ("[T]he federal tax issues raised by the Oregon Child

not apply in “unusual circumstances.”⁴⁹ The memo even expressly contemplates that nominal donations to state-controlled funds may be appropriately characterized as taxes.

The Tax Court has never endorsed the 2011 memo’s reasoning, nor has any court ever addressed tax credits received through a donation to a state-controlled fund. The Tax Court itself has reserved judgment on whether state tax credits received through a nominal donation establish that a “sale or exchange” or other “quid pro quo transaction” has occurred.⁵⁰ Thus, the 2011 memo reflects a weak source of authority for the charitable contribution strategy.⁵¹

Ultimately, the interaction between state tax credits and section 170 remains uncertain. The existing cases do not expressly deal with transactions where the contemplated state tax benefits exceed the amount donated, so their relevance to the charitable contribution strategy may be limited. Consequently, if the Service wants to address the charitable contribution

Care Credit [arising from donations to state and private entities] are significant and should be considered by the Service’s national office, along with the other issues related to the federal tax treatment of state tax credits currently under study.”); I.R.S. CCA 200238041 (Sept. 20, 2002) (“[W]e have determined that these issues [related to the Colorado conservation easement credit], along with certain other issues raised in connection with the federal tax treatment of state tax credits, would be best addressed in official published guidance.”).

⁴⁹ If state legislation designed to circumvent federal law does not present an unusual circumstance, it is hard to imagine what would. See Marie Sapirie, *The Trouble with Charitable Deduction Workarounds*, 160 TAX NOTES 7 (2018) (“[U]nusual circumstances are present when a state attempts to subvert federal tax law.”).

⁵⁰ *Tempel v. Commissioner*, 136 T.C. 341, 344 (2011) (reserving on whether a transaction in which the taxpayer obtained state tax credits through an easement donation to a private organization could be classified as a “sale or exchange of the easement” or “a quid pro quo transaction”; neither the Service nor the taxpayer had so contended), *aff’d sub nom. Esgar Corp. v. Commissioner*, 744 F.3d 648 (10th Cir. 2014). In *Tempel*, the state tax credits were granted by the state, not the recipient organization, so the court reached the proper conclusion. See *Tempel*, 136 T.C. at 353 (“Petitioners did not acquire the State tax credits by purchase. It was the State’s unilateral decision to grant petitioners the State tax credits as a consequence of their compliance with certain State statutes.”). On appeal, the Tenth Circuit also contemplated that a *quid pro quo* analysis could apply to an easement contribution, at least in some circumstances. See 744 F.3d at 660 n.13 (“If this were a like-kind exchange (conservation easements in exchange for tax credits), then this would negate the charitable nature of the [t]axpayers’ contribution.”).

⁵¹ See Peter L. Faber, *supra* note 44 (summarizing cases cited in the 2011 memo and concluding that the memo “is a slim reed on which to rely for the proposition that the charitable contribution proposals that have been suggested to get around the state and local tax deduction limitation would work”).

strategy under a section 170 based approach, it should proceed through regulation rather than litigation.⁵²

B. Income Inclusion

If a taxpayer recognizes income on the receipt of a state tax credit, the charitable contribution strategy will fail. Even if a section 170 deduction were fully allowed, the resulting income inclusion would negate or severely limit the benefit of that deduction.⁵³ The taxpayer would be no better off than if had she paid taxes directly.⁵⁴

To include state tax credits received in a taxpayer's gross income, the Service might argue that discharge of indebtedness income arises whenever a state tax credit applies against a taxpayer's state tax liability.⁵⁵ In general, when a creditor forgives a portion of a debtor's loan, the amount so forgiven reflects income under section 61(a)(12). Using that principle, the Service might (questionably) argue that the grant of a state tax credit should be treated as the forgiveness of debt. The debtor-taxpayer will not need to make a tax payment she was otherwise obligated to make. Thus, an accession to wealth arises.

But a government-taxpayer relationship differs from an ordinary debtor-creditor relationship. Most notably, a tax liability does not arise through the extension of credit.⁵⁶ Therefore, discharge of indebtedness income

⁵² As discussed in Part II.C., the Service should argue that the nominal donations remain taxes under section 164, such that section 170 simply does not apply. Substance over form principles provide the soundest route to showing that donations under the charitable contribution strategy reflect payments made in exchange for state tax credits.

⁵³ Suppose, for example, that a taxpayer donated \$100,000 to a state-controlled fund and claimed a \$100,000 section 170 deduction. If the state used the full credit model, the taxpayer simultaneously recognize \$100,000 of income, generally washing out the benefit of the deduction. The taxpayer would enjoy a \$100,000 basis in the state tax credits she received as part of the transaction and would enjoy a deduction when applying them against her tax liability, but section 164(b)(6) would limit the deduction to \$10,000. Thus, the taxpayer would generally be in the same position that she would be in had she directly paid her \$100,000 tax liability.

⁵⁴ See *id.*

⁵⁵ See I.R.S. Coordinated Issue Paper, *supra* note 43 at *3 (I.R.S. May 23, 2008) (noting that discharge of indebtedness income may potentially arise through the cancellation of a state or local tax debt).

⁵⁶ But see *Yale Ave. Corp. v. Commissioner*, 58 T.C. 1062 (1972). In *Yale Ave.*, solvent taxpayers who compromised a tax liability with the Service recognized income from the discharge of indebtedness. However, the court reserved on whether a discharged tax liability might be excluded under the theory that the lia-

principles probably do not apply here.⁵⁷ Additionally, the use of a state tax credit reflects the satisfaction of a liability, not the discharge of one.⁵⁸

If a court holds that the receipt of a state tax credit creates gross income, its underlying analysis likely would not depend on discharge of indebtedness principles or on analogies to prior cases.⁵⁹ A court adopting the inclusionary approach would probably emphasize section 61's breadth and the absence of any applicable statutory exclusion.⁶⁰ It would likely also emphasize that, though some state-provided benefits are excludable from

bility arose under a transaction in which the taxpayer was provided no benefit. For a challenge to the position that discharged tax liabilities reflect gross income, see Richard C.E. Beck, *Is Compromise of a Tax Liability Itself Taxable? A Problem of Circularity in the Logic of Taxation*, 14 VA. TAX REV. 153 (1994). In an internal memorandum, the Service relied on contract principles to conclude that section 7122 compromises, at least, do not create COD income. See I.R.S. SCA 1998-39 (“Cancellation of a tax debt by means of an offer in compromise does not give rise to discharge of indebtedness income. . . . [A] compromise of the interest portion of a tax debt did not give rise to income from the discharge of indebtedness because ‘[t]he effect of the compromise settlement itself and the intentions of the parties in entering into it was to extinguish all tax liabilities included in the items making up the compromise.’”) (quoting *Eagle Asbestos & Packing Co. v. United States*, 348 F.2d 528 (Ct. Cl. 1965)).

⁵⁷ See Lawrence Zelenak, *Cancellation-of-Indebtedness Income and Transactional Accounting*, 29 VA. TAX REV. 277, 316 (2009) (a taxpayer whose federal income tax liability is cancelled receives no benefit excluded from income by reason of the existence of the federal income tax liability). Professor Zelenak does not address state tax credits but his framework, if extended to them, would counsel against including state tax liabilities paid via a state-granted credit in gross income, since no benefit arose through the underlying liability. See *id.* at 279 (arguing that section 61(a)(12) income “should not follow from the cancellation of a no-benefit debt”).

⁵⁸ See *infra* Part II.C.

⁵⁹ One might imagine unusual circumstances where, for example, a state granted tax credits to persons who provided services to the state. See, e.g., I.R.S. CCA 200227003 (Jan. 15, 2002) (property tax abatements for senior citizens as an inducement to work in state volunteer programs constituted gross income); I.R.S. CCA 200302045 (Dec. 3, 2002) (property tax exemptions offered to volunteer emergency responders for their services represented an in-kind payment for services and constituted gross income). See also *Watervliet Paper Co. v. Commissioner*, 16 B.T.A. 604 (1929). However, the charitable contribution strategy does not involve the provision of services by the transferor, so these materials would not be relevant to it.

⁶⁰ Under the prevailing judicial test, memorialized in *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), an item constitutes income when it reflects an accession to wealth, clearly realized, over which the recipient enjoys dominion and control. Cf. also Treas. Reg. § 1.61-14(a) (“Another person’s payment of the taxpayer’s income taxes constitutes gross income to the taxpayer unless excluded by law.”).

gross income, the typical state tax credit does not fall within one of the commonly excluded categories.⁶¹

On at least one occasion, the Tax Court acknowledged that the receipt of a state tax credit creates gross income. In *Snyder v. Commissioner*, the taxpayers held interests in a partnership that operated a racing facility.⁶² Under Ohio law, a racing facility operator kept a percentage of the wagers made at its facilities and paid a tax on the amount retained. Ohio law provided partial tax credits for an operator that made capital improvements to its facility, like the partnership in *Snyder* had.⁶³ The Service argued that the partnership should include those state tax credits in federal gross income, and the Tax Court agreed.⁶⁴

But on appeal, the case proceeded differently. The Service concluded that it and the Tax Court incorrectly addressed the federal tax treatment of state tax credits.⁶⁵ Rather than include those credits in income and allow a deduction for taxes paid, the Service conceded that the partnership should exclude the credits and correspondingly reduce its section 164 deduction. The Sixth Circuit, in an unpublished decision, accepted that view.⁶⁶

⁶¹ Cf. *Ginsburg v. United States*, 136 Fed. Cl. 1, 5 (2018) (rejecting general welfare exclusion for cash received from a refundable credit) (citing Rev. Rul. 2005-46).

⁶² *Snyder v. Commissioner*, 55 T.C.M. (CCH) 1334 (1988), *vacated and remanded without published opinion*, *Snyder v. Commissioner*, 894 F.2d 1337, 1990 WL 6953 (6th Cir. 1990).

⁶³ The Ohio statute did not use the word credit, but instead referred to the benefit as a “reduction.” Ohio Rev. Code Ann. § 3769.08(J)(1) (LexisNexis 1980). However, viewed through the lens of federal law, the Ohio program provided a credit, because it applied to only operators that made capital improvements and did not provide a broadly applicable tax decrease. Additionally, the statutory “reduction” operated like a credit and could be “carried forward” to other years. *Id.* See also *Snyder v. Commissioner*, 55 T.C.M. (CCH) 1334 at n.4 (referring to the “tax credit” under the Ohio statute).

⁶⁴ The taxpayers did not squarely reject an inclusionary approach to state tax credits. Rather, they argued that the state tax credits should be accounted for through a reduction in the basis of partnership property, with income recognized (and a deduction allowed) as those credits were used. But the Service successfully persuaded the Tax Court that income arose immediately, upon the certification of the taxpayer’s credits. See *Snyder v. Commissioner*, 55 T.C.M. (CCH) 1334 (1988) at *4 (“[T]he full amount of the tax reduction was income in the taxable year in which the certification was granted.”).

⁶⁵ *Snyder*, 1990 WL 6953, *4.

⁶⁶ *Id.* (“The Commissioner now agrees that the proper treatment of the [tax credit] is simply ‘to reduce the deductions available to [the partnership] for its pari-mutuel tax obligations, which reduced deductions accrue as those taxes become due. We agree too.’”) (brackets in original).

Later cases have generally adopted this exclusionary approach.⁶⁷ For example, when a taxpayer faces a \$30,000 state tax liability and receives a \$30,000 credit to apply against that liability, no income or deduction arises. As the Tax Court somewhat circularly explained, a state tax credit simply reduces the amount a taxpayer owed and its grant “is not itself a taxable event, ‘for the investor has received no money or other ‘income’ within the meaning of the Internal Revenue Code.’”⁶⁸

Before the TCJA established the SALT deduction limit, an inclusionary approach to state tax credits would have yielded similar results, at least in simple circumstances. Any amount included in income would be paired with an offsetting deduction for taxes paid, causing no change in tax liability.⁶⁹ But with the new limit, a \$30,000 inclusion would be offset only partially by the \$10,000 allowable deduction.

This new statutory framework changes the premise on which the Service adopted its exclusionary approach to state tax credits. No longer will excluded state tax credits be matched with reduced deductions. And administrative concerns alone can no longer justify an exclusionary approach.⁷⁰

Nonetheless, given existing case law, it would be risky for the Service to switch to an inclusionary approach, at least in the Tax Court.⁷¹ That court has now embraced an exclusionary approach, and its decision does

⁶⁷ See, e.g., *Maines v. Commissioner*, 144 T.C. 123, 134 (2015) (state tax credit that was not refunded, but was applied against existing liability, excluded from gross income); *Ginsburg v. United States*, 136 Fed. Cl. 1, 4 (2018) (nonrefundable portion of state tax credit is excluded from gross income “because it merely reduced the amount of tax that plaintiffs would have otherwise owed that year”). *But see infra* notes 102–108 and accompanying text.

⁶⁸ *Maines*, 144 T.C. at 134 (quoting *Randall v. Loftsgaarden*, 478 U.S. 647, 657 (1986)). *Randall* dealt with federal tax benefits, not state tax benefits, and it is unclear why the Tax Court relied on that case. *See infra* note 128.

⁶⁹ See also I.R.S. CCA 200708003 (Feb. 23, 2007) (concluding that a state military credit that is applied against a state tax liability is excludable and that it reduces “the amount available as a deduction for state income taxes under section 164(a)(3)”; *IRS Appeals Settlement Guidelines, New York State Qualified Empire Zone Enterprise Credit Real Property Taxes*, Tax Analysts Doc. 2013-10141 (Apr. 4, 2013) (“[The] consequence [of excluding a state tax credit] is generally a decrease in the deductible amount of state or local tax under I.R.C. § 164.”).

⁷⁰ See I.R.S. CCA 200238041 (Sept. 20, 2002) (because income included under section 61 would be offset by the section 164 deduction, it would be “unnecessary and overly complex to re-characterize” the grant and use of a state tax credit “as a deemed payment to the taxpayer, followed by a deemed payment by the taxpayer”).

⁷¹ But see *Consol. Edison Co. v. United States*, 10 F.3d 68 (2d Cir. 1993) (adopting inclusionary approach to state tax credits); *see infra* Part II.C.b.

not explicitly rely on an offsetting deduction rationale.⁷² Thus, the Service would need to ask the Tax Court to reverse its prior position, a request that the court would not take lightly.⁷³

C. Substance Over Form

Public commentary over the charitable contribution strategy usually focuses on section 170 and whether donated amounts satisfy that statute's requirements. But it is doubtful that section 170 reflects the correct starting point for analysis. In substance, the charitable contribution strategy involves the payment of taxes in a transaction subject to section 164. Consequently, under existing law, the Service can treat the taxpayer's nominal donation as a tax payment or as a deposit against her taxes. Alternatively, the Service may treat the taxpayer as having purchased state tax credits with her nominal donation, with tax payments arising as those credits are applied against her liability.

The first approach essentially disregards the tax credits granted and used under the charitable contribution strategy. That approach follows from the principles adopted by the Service and the Tax Court when addressing state tax credits. But the second approach enjoys a stronger theoretical foundation. Transactions involving state tax credits should establish independent federal tax consequences.

This Part will discuss the two substance over form approaches separately. However, the key distinction between them relates only to whether state tax credit transactions should be ignored or observed for federal tax purposes. And that distinction aside, the broader interpretive principles discussed for one approach will also apply to the other approach.

1. Donations as Tax Payments

To treat a taxpayer's nominal donation to a state-controlled fund as a payment of tax, the Service can rely on the familiar substance over form

⁷² *Maines*, 144 T.C. at 134.

⁷³ See *Lunsford v. Commissioner*, 117 T.C. 159, 164 (2001) ("We are, of course, cognizant of the role stare decisis plays in this Court and in other Federal courts, especially in the context of statutory construction."). The Tax Court's precedents would be less relevant for any challenge to New York or Connecticut's charitable contribution strategy, given the Second Circuit's inclusionary approach to tax credits. See *infra* notes 102–108 and accompanying text. If a case were properly appealable to the Second Circuit, the Tax Court would follow the precedent in that court, even if it conflicted with the Tax Court's own decisions. See *Golsen v. Commissioner*, 54 T.C. 742, 756–57 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

doctrine. Under that doctrine, courts usually disregard mere labels when characterizing transactions under the tax code. For example, if an employer transfers money to an employee and labels it a tax-free gift, that label will be disregarded if the transfer reflects compensation for the performance of services. Similarly, if one person transfers title in property to another while retaining all other incidents of ownership, then no disposition has occurred and no loss deduction may arise. These substance over form principles follow from the general rule that statutory terms should be given their ordinary meaning, not hyper-literal ones. The Tax Court has specifically applied substance over form principles to the federal taxation of state tax credits.⁷⁴

Substance over form principles help establish that the charitable contribution strategy involves the payment of taxes. After all, the taxpayer owes or will owe taxes to the state, the taxpayer transfers money to that state, and the state applies that money towards the taxpayer's liability through the granted tax credits. This two-way transaction differs from one where a taxpayer simply donates to the state and receives nothing in return. It also differs from a state's unilateral decision to reduce tax liabilities for taxpayers broadly.⁷⁵

Authorities under section 164 confirm that a substance over form analysis applies under the statute and that taxes may arise even if, as with the charitable contribution strategy, a taxpayer makes a payment to an entity or fund separate from the state treasury. In *Campbell v. Davenport*, for example, the taxpayer was a candidate in a primary election who had to pay a ballot access fee to his political party's county executive committee.⁷⁶ That fee, collected from all candidates, would go into an election fund, not the state treasury. The taxpayer argued that section 164 nonetheless allowed him a deduction for the fee he paid – it was really a tax.

⁷⁴ See *Maines*, 144 T.C. at 132 (rejecting taxpayer's argument that the court must follow state law labels related to a New York tax credit regime; "Federal tax law looks instead to the substance (rather than the form) of the legal interests and relationships established by state law.").

⁷⁵ See Rev. Rul. 79-315, 1979-2 C.B. 27 (broad Iowa tax rebates, effected through a deemed payment and refund/credit mechanism, were simply a means to effect a "statutory decrease" on the tax liabilities of individual taxpayers). Though the ruling does not go into further detail, the Service apparently believed that the Iowa "statutory decrease" was analogous to broadly lowering individual tax liabilities under section 1 of the federal tax code. See also Peter L. Faber, Comment, *Comment on Professor Stark's Prompt*, 9 COLUM. J. TAX L.-TAX MATTERS 9 (2018) ("[Rev. Rul. 79-315] involved an income tax rebate that was not paid in consideration for contributions or any other activity. It simply represented a state tax reduction."); Rev. Rul. 78-194, 1978-1 C.B. 24 (broadly applicable property tax rebates generally excluded from gross income to the extent of liability).

⁷⁶ 362 F.2d 624 (5th Cir. 1966).

The Fifth Circuit agreed. Though state law did not describe the payment as a tax, the court followed a revenue ruling which involved a New Mexico ballot access fee. That ruling advised that “whether a particular contribution or charge is to be regarded as a tax depends upon its real nature.”⁷⁷ Using that standard, the court found that the taxpayer had paid a tax. Though the payment went to a political party and not directly to the treasury, the party was acting on behalf of the state.⁷⁸ Also, the ballot access fee had a revenue raising function, further showing that it was a tax.⁷⁹

Regulations also show that whether a payment qualifies as a tax depends on its substance, not its label. For example, a registration fee paid to a state’s vehicle department will qualify as a personal property tax if it is based on the value of the car.⁸⁰ Under similar principles, a taxpayer’s trans-

⁷⁷ Rev. Rul. 57-345, 1957-2 C.B. 132 (quoted in *Campbell*, 362 F.2d at 628). See also 362 F.2d at 629 (“[W]e conclude here, as did the Commissioner in Revenue Ruling 57-345, that the primary purpose of the assessment is to raise revenue and that, therefore, it qualifies as a ‘tax’ within the provisions of Section 164.”). The Service later considered an arrangement similar to the one in Rev. Rul. 57-345 and concluded that the ballot access fee involved was not a tax under section 164. See Rev. Rul. 60-366, 1960-2 C.B. 63. However, the later ruling set forth a similar legal standard as the earlier one. See *Campbell*, 362 F.2d at 628 (“Although in both Rulings the Commissioner relies on basically the same definition and finds that the purpose of the assessment determines whether it is to be classified as a tax or as a fee, he obviously has had some difficulty in applying the definition.”). Thus, the Fifth Circuit did not err when it relied on the general language in Rev. Rul. 57-345, because Rev. Rul. 60-366 revoked that ruling only to the extent of any inconsistency. See also I.R.S. GCM 33186, 1966 WL 15823, *3 (Feb. 10, 1966) (“[W]hether a particular contribution or charge is to be regarded as a tax depends upon its real nature.”) (quoting G.C.M. 13191, re: North Dakota Hunting and Fishing Licenses (May 18, 1934)).

⁷⁸ When *Campbell* was decided, two district courts had already held that ballot access fees were deductible under section 164. See *Nichols v. United States*, 223 F. Supp. 709 (N.D. Ga. 1963); *Maness v. United States*, 237 F. Supp. 918 (M.D. Fla. 1965), *aff’d on other grounds*, 367 F.2d 357 (5th Cir. 1966). In *Maness*, the court emphasized that the ballot access fee went directly to the state secretary, not the state treasury, although *Campbell* did not consider that issue determinative.

⁷⁹ Congress had addressed this controversy in an amendment to section 164, though that amendment did not apply for the tax period at issue. See *Manufacturers’ Finance Corp. v. Vye-Neill Co.* 62 F.2d 627 n.4 (1st Cir. 1933) (“Since this case arose, the Revenue Act of 1964, P.L. 88-272, 78 Stat. § 19, 207(a), amended section 164(a) of the 1954 Code to allow deduction only of taxes specifically enumerated therein and those paid or accrued in carrying on a trade or business or in the production of income.”).

⁸⁰ Treas. Reg. § 1.164-3(c)(3) (“A tax may be considered to be imposed in respect of personal property even if in form it is imposed on the exercise of a privilege. . . . For example, an annual ad valorem tax qualifies as a personal property tax

fer to the state in satisfaction of her tax liability cannot become a donation through meaningless labels.

One might argue that taxpayers who participate in the charitable contribution strategy cannot have paid taxes under section 164 because the tax credits issued through that strategy make their tax liabilities disappear. But under this substance over form analysis, the tax credits, not the tax liability, disappear.⁸¹ In determining federal tax consequences, courts link together “all interdependent steps” of an arrangement, so that the “federal tax liability may be based ‘on a realistic view of the entire transaction.’”⁸² Lower courts have adopted these principles in different ways, and multiple judicial tests have emerged.⁸³ However, because under the charitable contribution strategy state tax credits arise directly from the nominal donation, their issuance and later use may be integrated under multiple potential tests.

Under the commonly used end-result test, for example, “the step transaction doctrine will be invoked if it appears that a series of separate transactions were prearranged parts of what was a single transaction, cast from the outset to achieve the ultimate result.”⁸⁴ The charitable contribution strategy easily satisfies that test because the taxpayer’s donation, the state’s grant of the tax credit, and the credit’s later use are each parts of a pre-arranged plan, enabled under a single statutory regime. Another common test, the interdependency test, links together transactional steps when the “legal relations created by one step would have been fruitless without completion of the later steps.”⁸⁵ From the eyes of an objective taxpayer, the nominal dona-

although it is denominated a registration fee imposed for the privilege of registering motor vehicles or of using them on the highways.”).

⁸¹ For a substance over form analysis that recognizes the grant and use of a state tax credit, *see infra* Part II.C.b.

⁸² *Commissioner v. Clark*, 489 U.S. 726, 738 (1989) (quoting 1 B. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 4.3.5, p. 4-52 (1981)). *See also Barnes Grp., Inc. & Subsidiaries v. Commissioner*, 593 F. App’x 7, 9 (2d Cir. 2014) (“The step transaction doctrine is a manifestation of the broader tax principle that substance should prevail over form.”); *CNT Invs., LLC v. Commissioner*, 144 T.C. 161, 193 n.33 (2015) (“We have described the step transaction doctrine, for example, as simply an extension or application of the ‘substance over form’ doctrine.”).

⁸³ *See Barnes Grp., Inc. v. Commissioner*, T.C.M. 109 (2013) (“Courts generally apply one of three alternative tests in deciding whether to invoke the step-transaction doctrine and disregard a transaction’s intervening steps: (1) the binding commitment test; (2) the end result test; and (3) the interdependence test.”), *aff’d sub nom. Barnes Grp., Inc. & Subsidiaries*, 593 F. App’x at 7.

⁸⁴ *Greene v. United States*, 13 F.3d 577, 583 (2d Cir.1994).

⁸⁵ *Greene*, 13 F.3d at 584 (citing *Am. Bantam Car Co. v. Commissioner*, 11 T.C. 397, 405, *aff’d*, 177 F.2d 513 (3d Cir. 1949)). Another test, the binding com-

tion would be fruitless without the later grant and use of the tax credit.⁸⁶ Thus, either the end-result test or the interdependency test would link together the nominal donation and the state tax credit transactions.⁸⁷ Once those steps are linked, the substance of the charitable contribution strategy reflects a payment of taxes under section 164 rather than a contribution or gift under section 170.

This analysis treats the substance over form doctrine as a tool of statutory interpretation, but it has often been used differently.⁸⁸ To varying de-

mitment test, links multiple steps only when a taxpayer is legally obligated to perform the later steps. The binding commitment test would not support treating a nominal donation as the payment of taxes because a taxpayer is not legally obligated to apply credits he receives against his tax liability. But as the Tax Court noted, the binding commitment test is “seldom used,” and in any event, the binding commitment, end result, and interdependency tests “are not mutually exclusive” and “a transaction need satisfy only one of the tests to allow for the step transaction doctrine to be invoked.” Barnes, T.C.M. 109 2013 WL 1629248 at *17. If a court adopted the binding commitment test to the exclusion of other tests, then the Service would more appropriately follow the second substance over form approach described in this Part. That is, it should treat the taxpayer’s nominal donation to a state-controlled as a purchase of state tax credits because those credits, under binding law, would arise through his donation.

⁸⁶ Taxpayers, of course, sometimes freely donate to a state without the expectation of a credit, and the absence of any credit would not, in these circumstances, render their efforts fruitless. However, the charitable contribution strategy involves statutes under which tax credits must be granted for a donation, and those statutes should inform how a court applies the interdependency test.

⁸⁷ This does not imply that any donation that gives rise to a state tax credit must be characterized as the payment of taxes. For example, where a state tax credit arises through a taxpayer’s donation to a private organization, the transaction could not be collapsed in a sensible way, because the recipient of the donation differs from the grantor of the credit. In only unusual circumstances, such as where the private organization has acted as the agent for the state, should the donation qualify as a tax payment.

⁸⁸ The preceding step-transaction analysis used expected taxpayer behavior only to help characterize a transaction, as a precursor to determining its federal tax consequences. Thus, the step-transaction doctrine, as applied here, could be taxpayer favorable or unfavorable. For example, if a foreign country, for whatever reason, adopted an arrangement like the charitable contribution strategy, then a taxpayer would benefit from collapsing the transactional steps in the manner described. Her nominal donation would establish a section 901 foreign tax credit, rather than (at most) a mere deduction. Also, should collapse the steps of the charitable contribution strategy by using objective inferences gleaned from an examination of the statutory scheme, and not by analyzing a taxpayer’s subjective thoughts. However, it is much too late to deny that the lower federal courts have often made subjective inquiries in step-transaction cases. *See, e.g., Superior Trading, LLC v. Commissioner*, 137 T.C. 70, 89 (2011) (“The end result test focuses on the parties’ subjective intent at the time of structuring the transaction.”); *Del Commercial Props., Inc. v.*

grees, district and circuit courts have invoked the phrase “substance over form” or other common law doctrines to deny a taxpayer’s claimed benefit despite her compliance with a statute.⁸⁹ These courts typically find that a tax-avoidance motive negates any otherwise available tax benefit.

However, courts should not approach the charitable contribution strategy this way. Substance prevails over form, but not over statutes.⁹⁰ It is one thing to argue, as this article does, that a payment which bears all the key characteristics of a tax, rather than a contribution or gift, comes within section 164.⁹¹ But it is another thing to say that a *bona fide* contribution or gift fails under section 170 because of judge-made tests.

Nonetheless, the Service has persuaded many lower courts to sometimes adopt extra-statutory tests that focus on a taxpayer’s motive.⁹² If the

Commissioner, 251 F.3d 210, 213 (D.C. Cir. 2001) (transactional step may be “disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes”).

⁸⁹ See Joseph Isenbergh, *Musings on Form and Substance in Taxation: Federal Taxation of Incomes, Estates, and Gifts*, 49 U. CHI. L. REV. 859, 865 (1982). More recently, courts have referred to the “economic substance doctrine” or the “sham transaction doctrine,” rather than the “substance over form doctrine.” Although one can make principled distinctions between the various common law tax doctrines, the doctrines are often referred to interchangeably; see *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9th Cir. 1988) (“The casebooks are glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify.”); Joint Committee on Taxation, JCX-1-10 (No. 8), 2010 WL 933940 at *7 (Mar. 11, 2010) (“[C]ourts have developed several doctrines that can be applied to deny the tax benefits of a tax-motivated transaction . . . These common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts, the IRS, and litigants.”).

⁹⁰ See *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779, 787 (6th Cir. 2017) (“[I]t’s odd to reject a Code-compliant transaction in the service of general concerns about tax avoidance. Before long, allegations of tax avoidance begin to look like efforts at text avoidance.”).

⁹¹ *Mazzei v. Commissioner*, 150 T.C. No. 7, 2018 WL 1168766, at *24 (“When someone calls a dog a cow and then seeks a subsidy provided by statute for cows, the obvious response is that this is not what the statute means.”) (quoting Isenbergh, *supra* note 89).

⁹² See Amandeep S. Grewal, *Economic Substance and the Supreme Court*, 116 TAX NOTES 969, 970–78 (2007) (summarizing various lower court cases); Jacobs Eng’g Grp., Inc. v. United States, (1977) (No. CV 96-2662) 1997 WL 314167, at *2 n.5 (C.D. Cal. Mar. 5, 1997) (“[S]ubstance over form’ is a somewhat disturbing doctrine. . . . [T]he doctrine is fundamentally anti-majoritarian, as unelected bureaucrats are given the power to rewrite laws enacted by Congress and the President.”); *In re CM Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002) (“[C]ourts have looked beyond taxpayers’ formal compliance with the Code and analyzed the fun-

Service challenges the charitable contribution strategy under those tests, it can point to various transactional features that establish tax-avoidance motives, such as the lack of meaningful nontax purposes or objectives.⁹³ That approach would be unsound, because extra-statutory tests reflect an improper judicial gloss on the tax code and because the United States Supreme Court has never embraced those tests. The Service should instead rely on substance over form principles only to the extent consistent with statutory language.⁹⁴ And under section 164, the relevant question is whether the taxpayer has paid a tax, not whether the taxpayer subjectively wanted to avoid the SALT deduction limit.

2. Donations as Purchase of Credits

Given the new SALT deduction limit, the Service should revisit whether tax credits eliminate tax liabilities.⁹⁵ If the Service does so, it can properly treat the charitable contribution strategy as an arrangement involving the

damental substance of transactions. Economic substance . . . is the Government's trump card; even if a transaction complies precisely with all requirements for obtaining a deduction, if it lacks economic substance it simply is not recognized for federal taxation purposes, for better or for worse.”).

⁹³ Other scholars may debate whether the charitable contribution strategy satisfies the elements required to apply extrastatutory tests. See, e.g., Daniel Shaviro, *Restoring state and local tax deductibility through self-help*, START MAKING SENSE, Jan. 9, 2018, <http://danshaviro.blogspot.com/2018/01/restoring-state-and-local-tax.html> (discussing charitable contribution strategy and extrastatutory principles). But because this writer believes that those elements, even if present, cannot override statutory language, no further parsing of those factors will be undertaken here. Additionally, I.R.C. § 7701(o), which partially codifies the economic substance doctrine, expressly does not apply to personal deductions of individuals, like those implicated by the charitable contribution strategy. See I.R.C. § 7701(o)(5)(B).

⁹⁴ See Amandeep S. Grewal, *Economic Substance and the Supreme Court*, 116 TAX NOTES 969 (2007). In *United States v. Woods*, the Supreme Court noted that the district court had applied an extrastatutory test (the economic substance doctrine), but it declined to express any view of it. *United States v. Woods*, 571 U.S. 557, 562 n.1 (2013); see also Brief for Professor Amandeep S. Grewal as Amici Curiae Supporting Neither Party, *United States v. Woods*, 134 S. Ct. 557 (2013) (No. 12-562), 2013 WL 2470140, at 14–20 (urging Court to make reservation of this sort).

⁹⁵ In litigation, the Service has repeatedly argued that the application of a state tax credit eliminates the related tax liability. See *supra* Part II.B. But it has not made that argument where the state tax credit arises through a transfer to the state itself. As Part II.B discussed, internal memos reflect uncertainty on the issue. See *supra* note 44. In litigation, the Service can properly argue that section 164 applies to the use of state tax credits when they arise from payments to the state. The Service should also change its approach to state tax credits in some other contexts, but it need not do so to address the charitable contribution strategy.

satisfaction of tax liabilities. Under this approach, the taxpayer's nominal donation would be characterized as the purchase of state tax credits. This would negate the benefits sought under the charitable contribution strategy because no section 170 deduction arises under a purchase transaction. The later use of the purchased tax credits to satisfy the taxpayer's tax liability would be deductible, but subject to the SALT deduction limit.

The Service and courts should treat tax credits as satisfying, rather than eliminating, tax liabilities. Under the tax code, a tax liability generally vanishes only under a process called "abatement."⁹⁶ But a credit does not abate a tax liability. It applies after the tax has been computed. Section 1, for example, fixes an individual's income tax liability, and various later provisions describe things that are "allowed as a credit against the tax imposed" by that section.⁹⁷ This shows that a tax liability (that is, the tax imposed) arises and becomes fixed before any credit may be applied.

Section 6401(b)(1) also reflects this principle. Under that provision, an overpayment may arise when refundable tax credits exceed the tax imposed, as reduced by nonrefundable credits.⁹⁸ This provision shows that Congress understands that the "tax imposed" by the code refers to the amount determined before applying any credits. That is, if the tax imposed refers to a taxpayer's post-credit liability, this provision would lead to bizarre results.

For example, suppose that a taxpayer has \$10,000 in refundable credits, no nonrefundable credits, and faces a \$10,000 income tax imposed under section 1. On these facts, there should be no refundable overpayment because the taxpayer's credits equal his tax liability. But if the "tax imposed" must be computed with reference to tax credits, then the taxpayer will get a

⁹⁶ See I.R.C. § 6404(a) (authorizing the abatement of excessive, untimely, erroneous, or illegal assessments); see also MICHAEL I. SALTZMAN & LESLIE BOOK, IRS PRACTICE AND PROCEDURE ¶ 11.13 (2d ed. 1991) ("Abatement of an unpaid assessment cancels the assessment."). Assessment refers to the formal procedure through which the Service records a taxpayer's liability and fixes the amount payable. See *id.* at ¶ 10.01; see also I.R.C. § 6201(a) (establishing Service's assessment authority).

⁹⁷ See, e.g., I.R.C. §§ 21(a)(1), 22(a). These and similar credits will generally apply against any of the taxes imposed by Chapter 1 of the code.

⁹⁸ See I.R.C. § 6401(b)(1) ("If the amount allowable as credits under subpart C of part IV of subchapter A of chapter 1 (relating to refundable credits) exceeds the tax imposed by subtitle A (reduced by the credits allowable under subparts A, B, D, and G of such part IV), the amount of such excess shall be considered an overpayment."). Through this provision, if a taxpayer has a \$10,000 refundable credit, a \$6000 tax liability, and a \$1000 nonrefundable credit, his overpayment will be \$5000. This figure is reached by taking the excess of the \$10,000 tax liability over \$5,000, with the latter figure representing the tax imposed (\$6000) as reduced by the nonrefundable credits (\$1000).

\$10,000 refund (that is, refundable credits of \$10,000 over \$0 of tax imposed, with the latter amount being computed after application of credits). This cannot possibly be what Congress means when it refers to the “tax imposed” on a taxpayer.⁹⁹

The procedural steps related to determining the tax imposed on a taxpayer also reveal why state tax deductions should be ignored under section 164, but state tax credits should not be. Tax deductions reflect items used to arrive at a tax liability, and no one would seriously suggest that a taxpayer has paid taxes under section 164 when she claims a deduction. That would be as strange as suggesting that a taxpayer has paid taxes when she enjoys an exclusion.¹⁰⁰ But tax credits, unlike deductions and exclusions, apply against a determined tax liability and their use may reflect tax payments.¹⁰¹

Consol. Edison v. United States illustrates these principles.¹⁰² In that case, New York City, facing a financial crisis, offered discounts (effectively, credits) to taxpayers who prepaid their real property taxes. Con Edison took advantage of this program and satisfied a \$51 million real property tax

⁹⁹ Similarly strange results occur if one focuses on only nonrefundable credits and assumes only those credits reduce the tax imposed. Suppose that a taxpayer has \$50,000 of refundable credits and \$12,500 of nonrefundable credits, and faces a \$25,000 tax imposed under section 1. This taxpayer should end up with a \$37,500 refund, reflecting the excess of the \$50,000 refundable credits over \$12,500 (the \$12,500 figure would reflect the tax imposed on her, \$25,000, reduced by nonrefundable credits of \$12,500). But if the “tax imposed” must take into account nonrefundable credits, then the taxpayer will enjoy a \$50,000 refund, reflecting the excess of \$50,000 over \$0 (the “tax imposed” is now \$12,500, since it is computed with reference to nonrefundable credits, and, under the language of the statute, the tax imposed is further reduced to \$0 by the nonrefundable credits of \$12,500). This bizarre result again shows that the “tax imposed” on a taxpayer is the amount determined before applying any tax credits. Visually minded readers will note that various tax forms, such as the Form 1040, first call for the computation of the tax owed and only then apply tax credits to determine the amount overpaid or the net amount due. See, e.g., Form 1040 (2017) (lines 63, 75, and 78).

¹⁰⁰ See, e.g., *Cummings v. United States*, 866 F. Supp. 2d 42, 48 (D. Mass. 2011) (holding that where property enjoyed statutory exemption from assessment, no section 164 deduction was allowed; “[T]he exempted amounts of tax were never assessed or imposed on the taxpayer in the first place.”).

¹⁰¹ The 2011 Service memo missed this point when it concluded there was “no reason under [the case law] to distinguish between the value of a state tax deduction, and the value of a state tax credit.” I.R.S. CCA 201105010 (Feb. 4, 2011). See also Sarah K. Johnson, *Making a Profit From Charitable Donations in South Carolina*, 73 ST. TAX NOTES 527, 531 (2014) (“[The memo] provides little explanation of why a 100 percent tax credit should be analyzed under the same test as a tax deduction.”).

¹⁰² *Consol. Edison Co. v. United States*, 10 F.3d 68, 74 (2d Cir. 1993).

bill with a \$50 million prepayment.¹⁰³ Litigation followed over the transaction's proper federal tax treatment.

The parties did not "seriously dispute" that the \$1 million discount reflected gross income under section 61.¹⁰⁴ But Con Edison claimed that it could exclude the discount under section 103, which relates to tax-exempt interest on state and local bonds. The Second Circuit rejected that argument, emphasizing that the discount arose through the city's "taxing power, not its borrowing power."¹⁰⁵ Con Edison thus needed to include \$1 million in income.

The court held, however, that Con Edison also enjoyed a \$1 million deduction under section 164 because the prepayment discount did not simply "reduce Con Edison's underlying tax liability," as the government argued.¹⁰⁶ Instead, it reflected a "partial satisfaction of Con Edison's unreduced tax liability."¹⁰⁷ Thus, the taxpayer had paid or accrued taxes and enjoyed a deduction under section 164.¹⁰⁸

The Service can thus use a second substance over form approach to combat the charitable contribution strategy. Rather than disregard state tax credits, as under the first substance over form approach, the Service can treat a donation under the charitable contribution strategy as a purchase of state tax credits. That transaction would not trigger any gain or loss, but the later use of the acquired credits would establish a tax payment subject to the SALT deduction limit.¹⁰⁹

¹⁰³ Con Edison's precise liability for this portion of its real property taxes \$50,937,814. *See id.* at 70. Con Edison also made subsequent prepayments under different provisions of New York City law. *See id.*

¹⁰⁴ *Id.* at 71.

¹⁰⁵ *Id.* at 72.

¹⁰⁶ *Id.* at 74. *See also id.* ("The IRS argues that taxes never became 'due' in the amount of the discounts because the City forgave these taxes in exchange for Con Edison's prepayment.").

¹⁰⁷ *Id.* at 73.

¹⁰⁸ In its provisions offering incentives to taxpayers, the federal tax code does not use the term "discount." The discount under New York City law, when translated to federal principles, reflects a credit, because the discount was applied against a determined tax liability. *See id.* at 71 (under city law, the "discounts were . . . utilized to discharge Con Edison's full tax liability") (construing 1 N.Y. City Charter & Admin. Code Ann. § 1518(6) (Williams Press 1976)).

¹⁰⁹ For a Service memorandum following this approach for purchased state tax credits, see I.R.S. CCA 201147024 (Nov. 25, 2011) ("[When] the purchaser applies the tax credit to satisfy its state tax liability, the purchaser will realize gain or loss under section 1001 equal to the difference, if any, between the basis of the tax credit and the amount of liability satisfied by the application of the tax credit. In addition, the purchaser will be treated as having made a payment of state tax for pur-

This approach rests on a better theoretical foundation than the first substance over form approach. It properly recognizes that taxpayers make tax payments under section 164 when they apply credits against their liabilities. But the Service has resisted that principle in some contexts, and the first approach probably fits better with the Tax Court's case law on state tax credits.

Whether the Service advances the first substance over form approach or the second, a state might believe that its own laws should characterize a taxpayer's transfer. Consequently, a state may change its laws so that the charitable contribution strategy does not create tax credits. The revised legislation might provide taxpayers with abatements as consideration for their nominal donations. This change to state tax law would allegedly ensure that section 164 does not apply to the charitable contribution strategy. Taxpayers would not have used any credits and thus could not have paid any taxes.

But federal principles, not state law labels, control characterizations under the tax code.¹¹⁰ If a taxpayer has a fixed tax liability and satisfies that liability through a payment to the state, then the taxpayer has paid taxes under section 164. Simply calling it an "abatement" changes nothing.¹¹¹ As Congress understands things, abatements occur when taxes are erroneously, illegally, or excessively assessed,¹¹² not when a taxpayer satisfies her tax liability.¹¹³

poses of section 164(a)."). *See also* Rev. Rul. 86-117, 1986-39 I.R.B. 19 (taxpayer recognized gain when paying state inheritance tax liability with property whose fair market value exceeded its basis).

¹¹⁰ *See Burnet v. Harmel*, 287 U.S. 103, 110 (1932) ("State law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law. . . . The state law creates legal interests, but the federal statute determines when and how they shall be taxed.").

¹¹¹ Labels like "tax reduction" and "discount" do not control, either. *See supra* notes 63 and 108.

See also Maines v. Commissioner, 144 T.C. 123, 132 (2015) (if labels controlled, "a state could undermine federal tax law simply by including certain descriptive language in its statute"). *Cf. also* I.R.C. § 856(c)(2)(E), (c)(3)(E) (acknowledging that "abatements and refunds of taxes on real property" could potentially create gross income for purposes of testing whether a corporation qualifies as a real investment trust). The section 856 provisions could not sensibly mean that all abatements and refunds create gross income, given that those things often create no accession to wealth. Congress probably had in mind circumstances that implicated the tax benefit rule.

¹¹² *See* I.R.C. § 6404(a).

¹¹³ A Service memorandum recognizes that an abatement under state law may be classified differently under the federal tax code. *See* I.R.S. CCA 200227003 (July 5, 2002) (a \$500 property tax "abatement" reflected compensation income for

The case law on state tax credits emphasizes federal law's significance.¹¹⁴ In *Ginsburg v. United States*, for example, the taxpayers enjoyed New York state tax credits through their participation in a redevelopment program.¹¹⁵ However, they had a small state tax liability and under the statutory regime were thus eligible for cash refunds. New York law called their refunds "overpayments."¹¹⁶

The taxpayers argued that they recognized no income under the federal tax code because when a taxpayer overpays state taxes and receives a refund, he generally recognizes no income.¹¹⁷ The government countered that state law labels could not govern federal tax consequences. The purported refund was simply a cash transfer for which no exclusion rule applied.¹¹⁸

The claims court agreed with the government, holding that the taxpayers' refund "was nothing more than a cash transfer from the state to the taxpayer."¹¹⁹ The New York statute calling the cash transfer a refund could not control the analysis. Otherwise, taxpayers and the state could together "manipulate federal income tax laws."¹²⁰ The taxpayers thus recognized income from the state transfer.

Under similar principles, state law labels should not govern the federal tax consequences from the charitable contribution strategy. If a taxpayer

the performance of services in a state volunteer program, given specific features of the statutory regime). The memorandum also acknowledged that the taxpayer would enjoy a deduction under section 164. *See id.* ("Because \$500 of the earnings is credited to a senior citizen's property tax bill, the \$500 credit is deductible under section 164 even though state law treats it as an abatement or reduction in tax.") (citing *Consol. Edison Co. v. United States*, 10 F.3d 68 (2d Cir. 1993)).

¹¹⁴ *See also Maines v. Commissioner*, 144 T.C. 123, 132 (2015) ("Our precedents establish that a particular label given to a legal relationship or transaction under state law is not necessarily controlling for federal tax purposes.").

¹¹⁵ *Ginsburg v. United States*, 136 Fed. Cl. 1, 3 (2018).

¹¹⁶ *Id.* at 4 (citing N.Y. Tax Law § 33 (McKinney)). The taxpayers' tax credits exceeded their tax liability by about \$1.9 million, and New York law offered them a choice. They could either take a cash payment equal to the credit or defer the credit to another year, when they might have a liability against which to apply it. They went with the cash payment.

¹¹⁷ Taxpayers usually exclude bona fide refunds of state taxes, except to the extent their prior payment established deductions. *See Kadunc v. Commissioner*, 73 T.C.M. (CCH) 2082, at *1 ("[I]f a tax was deducted on a prior year's return . . . a subsequent recovery by the taxpayer of such tax must be included in gross income in the year the recovery is received."); *see also I.R.C. § 111*.

¹¹⁸ The Service had taken the same position in a letter to a Congressman from New York. I.R.S. Info. Ltr. 2013-0009 (Mar. 29, 2013) (summarizing prior internal memos).

¹¹⁹ *Ginsburg*, 136 Fed. Cl. at 4.

¹²⁰ *Id.*

makes a payment to the state and that payment satisfies her tax liability, it makes no difference whether the state calls it a tax.¹²¹ Substance prevails over form.

Also, because section 164 does not refer to a taxpayer's motives, those motives should not control whether a transfer qualifies as a tax under the statute.¹²² Suppose, for example, a taxpayer completes her Form 1040 or state law equivalent and correctly determines she owes \$5,000. If the taxpayer submits the payment not because the law demands it, but because she bursts with patriotism and wants to help fund her government, the payment will remain a tax. The application of the payment against her tax liability, not the thoughts floating in her head, establishes the character of her transfer. For the charitable contribution strategy, even if a taxpayer makes a nominal donation for reasons unconnected to tax avoidance, the state's use of the nominal donation to satisfy her tax liability (through the credit mechanism) establishes that section 164, and not section 170, applies to the arrangement.

III. REGULATORY RESPONSES AND POLICY CONSIDERATIONS

Under existing law, the charitable contribution strategy should fail. As described in Part II.C, any amounts nominally donated to a state-controlled fund, to the extent credited against the taxpayer's liability, reflect taxes paid under section 164 and not charitable contributions under section 170. The Service could also potentially attack the strategy under a *quid pro quo* analysis, a gross income analysis, or even under extra-statutory tests.

But the Service recently announced that it would propose regulations addressing the charitable contribution strategy.¹²³ This Part first describes the Service's announcement and analyzes the different approaches the agency might take. After discussing the potential regulatory approaches, this Part considers and rejects arguments that the Service should validate the charitable contribution strategy.

¹²¹ See *Maines v. Commissioner*, 144 T.C. 123, 133 (2015) ("The Maineses have a legal *interest* in the giant credits that New York law entitles them to. . . . But federal tax law has its own say in how to characterize those payments under the Code.").

¹²² But see *supra* notes 92–94 and accompanying text (discussing the Service's use of extrastatutory doctrines, which often focus on tax avoidance motives).

¹²³ See I.R.S. Notice 2018-54, 2018-24 I.R.B. 750. Tax regulations are generally drafted with input from both the Service and the Treasury Department, and are formally issued as Treasury Regulations. However, for ease of exposition, this article will assume that only the Service plays a role in the rulemaking.

A. Potential Approaches

Although several senior government officials quickly questioned the charitable contribution strategy,¹²⁴ the Service first formally acknowledged that strategy in Notice 2018-54.¹²⁵ That notice states that the Service will issue regulations on state laws that purportedly allow taxpayers to characterize donations to state-controlled funds “as fully deductible charitable contributions.”¹²⁶ The notice expresses concern over those laws, describing them as efforts to “circumvent the new statutory limitation on state and local tax deductions.” It also warns that “taxpayers should be mindful that federal law controls the proper characterization of payments for federal income tax purposes.” Thus, though the notice does not describe any anticipated rules, its language implies that the Service will issue regulations that challenge the charitable contribution strategy.

The remainder of this part analyzes different approaches the Service might take through those regulations. It uses the same analytical frameworks employed in Part II except it focuses on the issues through the rule-making lens. It concludes that the Service should address the charitable contribution strategy through substance over form principles because that approach will avoid some difficulties posed by the *quid pro quo* and income inclusion approaches. Broader questions related to state tax credits should be addressed in a separate rulemaking project.

¹²⁴ See, e.g., Aubree Eliza Weaver, *Mnuchin: Deducting property tax as charity is ‘ridiculous,’* POLITICO (Jan. 11, 2018, 3:23 PM) (“I think it’s one of the more ridiculous comments to think you can take a real estate tax that you are required to make and dress that up as a charitable contribution.”) <https://www.politico.com/story/2018/01/11/mnuchin-property-tax-as-charity-ridiculous-336543>; Richard Rubin, *Treasury Skeptical About States Allowing Charitable Giving to Work Around New Cap*, WALL ST. J. (Jan. 25, 2018, 5:19 PM) <https://www.wsj.com/amp/articles/treasury-is-skeptical-about-states-allowing-charitable-giving-to-work-around-new-cap-1516905524> (“Treasury Department tax experts are skeptical about states allowing taxpayers to make charitable contributions to circumvent a new cap on deductions for state and local taxes, a department official said.”).

¹²⁵ I.R.S. Notice 2018-53, 2018-24 I.R.B. 750, 750 (June 11, 2018).

¹²⁶ It is unclear from the Notice whether the Service will issue guidance under the private credit model. The notice describes potential transfers to state-controlled funds and “other transferees specified by the state,” suggesting that the Service has concerns over the private credit model. However, the Notice also refers to state legislative measures enacted or proposed in response to the new SALT deduction limit, and those measures generally follow only the full and partial credit models.

1. Quid Pro Quo

Because the charitable contribution strategy contemplates deductions under section 170, the Service might issue guidance under that statute. Presumably, any regulations would address whether a nominal donation to a state-controlled fund qualifies as a charitable contribution. Under one possible approach, the regulations might state that a transfer cannot so qualify whenever the anticipated tax benefits, whether in the form of deductions or credits, exceed the amount transferred. Under this approach, when a taxpayer in the 20% federal bracket donates \$100 to a charity and receives \$90 in state tax credits, no deduction would be allowed. The total anticipated benefits (\$90 in state tax credits and a federal deduction worth \$20) would have exceeded the amount transferred (\$100).

This approach creates some anomalies because it assumes what it sets out to determine – whether a taxpayer enjoys a section 170 deduction. That is, we assumed that the taxpayer would enjoy a federal deduction worth \$20 in measuring her anticipated tax benefits from the donation, but then ultimately denied her that deduction. And if her federal deduction were in fact zero, that would mean that her donation (\$100) exceeded her anticipated tax benefits (\$90), which implies that her deduction *should* be allowed. This line of analysis raises obvious problems, and any section 170 regulations should not consider a taxpayer's anticipated federal tax benefits.

The Service might instead issue regulations stating that the section 170 deduction must be reduced for only state tax credits that arise under the charitable contribution strategy. Under this approach, when a taxpayer in a 20% federal tax bracket donates \$100 to a state-controlled fund and receives \$90 in state tax credits, her deduction would be \$10. By excluding the federal deduction from the analysis, the section 170 computation becomes straightforward.

This approach does not establish any unwarranted distinctions between federal tax benefits and state tax benefits. In determining tax liabilities, there is a proper difference between ignoring benefits that arise within one tax system and ignoring tax benefits that arise under a separate system.¹²⁷ If the federal tax code taxes the value of federal deductions or exclusions,

¹²⁷ See Lawrence Zelenak, *SALT Ceiling Workarounds and Tax Shelters*, 89 ST. TAX NOTES 365, 376–77 (2018) (ignoring federal tax benefits under the federal income tax system “logically follows from the fact that the income tax features a tax-inclusive base” . . . “[T]he effect of state tax credits on the amount of federal charitable deductions has nothing to do with the tax-inclusive character of the federal income tax.”).

strange and circular results would follow.¹²⁸ Circularity problems generally do not arise, however, if the federal tax system takes into account tax credits received under a state's system. Those credits simply reduce the section 170 deduction.¹²⁹

Nonetheless, because many taxpayers prepare their federal tax returns before preparing their state tax returns, some challenges may arise. A taxpayer may not know that she must reduce her federal charitable deduction until she files her state tax return, because her state tax credit will be computed on that return. But to fill out her state tax return, she might need to know some figures from her federal form, especially if her state tax liability depends on her federal taxable income.¹³⁰

Intertwined tax systems no doubt present compliance questions, but we now have years of principles and practices to help address them.¹³¹ And ra-

¹²⁸ In some circumstances, the federal tax code will include federal tax credits in gross income. *See I.R.C. § 87* (gross income includes some federal tax credits related to alcohol fuels and biodiesel fuels). Usually, however, a tax system, whether at the federal level or state level, will not include tax credits granted by that system in income. Doing so would limit the effect of the credit, depending on the taxpayer's marginal tax rate. *See also Va. Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129, 141 n. 16 (4th Cir. 2011) ("[I]t would defeat the purpose of a tax credit if the credit had to be reported as income before it could be used to offset income."). This principle may also apply to different statutory regimes within a single level of government, as illustrated in *Randall v. Loftsgaarden*, 478 U.S. 647 (1986). In that case, defrauded investors sought damages under the federal securities laws. A provision under those laws reduced the available damages by "the amount of any income received" from the securities. *See id.* at 651. The investors had purchased partnership interests as part of an arrangement designed to secure pass-through deductions under section 704, but the Court held that that these tax benefits did not qualify as "income" under the securities law statute. *See id.* at 657 ("Unlike . . . a limited partner's distributive share of the partnership's capital gains or profits—the 'receipt' of tax deductions or credits is not itself a taxable event, for the investor has received no money or other 'income' within the meaning of the Internal Revenue Code.") (citing I.R.C. § 61).

¹²⁹ Of course, if a state, for some odd reason, made its credits depend directly on the taxpayer's federal tax liability, circularity problems would arise. But that would reflect a problem appropriately addressed through changing the state tax system, not through twisting section 170.

¹³⁰ As of last year, only six states use federal taxable income as the starting point to compute state taxable income. *See Nicole Kaeding, Does Your State's Individual Income Tax Code Conform with the Federal Tax Code?*, TAX FOUND. (Dec. 13, 2017) <https://taxfoundation.org/state-individual-income-tax-code-conform-federal-tax-code/> ("Twenty-seven states begin with federal adjusted gross income (AGI) as their income tax base. Six states use federal taxable income and three states use federal gross income as their starting point.").

¹³¹ *See, e.g., William C. Brown, A Primer on Income Tax Compliance for Multistate Pass-Through Entities and Their Owners*, 67 TAX LAW. 821, 856–58 (2014).

ther than use federal taxable income and create circularity issues,¹³² states can use federal adjusted gross income to begin tax computations, as most already do.¹³³ Principles to resolve other circularity issues, like those used to address state deductions for federal taxes, can also help.¹³⁴

Also, section 170 guidance on the charitable contribution strategy should not cause widespread compliance problems. That strategy appeals principally to wealthy taxpayers who itemize their deductions. The TCJA substantially increased the standard deduction under the federal tax code, and only around 10-15% of individuals will now itemize and potentially take section 170 deductions.¹³⁵ Thus, most taxpayers – that is, all non-itemizers and the many itemizers who will not participate in the charitable contribution strategy – will not face compliance issues under section 170.

However, if the Service relies on section 170 to address the charitable contribution strategy, at least one formidable problem arises. If the Service provides that a taxpayer must reduce her charitable contribution deduction for any state tax credits received through her donation, then she arguably must make a similar reduction for any state tax deductions she enjoys through that donation. But determining how to make that reduction may become highly complex.¹³⁶ For this reason, any regulations should not rely on section 170 to address the charitable contribution strategy. Instead, they should reiterate general substance over form principles and directly treat a donation under the charitable contribution strategy as a property purchase governed by sections 263 and 1011.¹³⁷

¹³² Federal adjusted gross income is computed without regard to the deductions offered by section 170. See I.R.C. §§ 62, 67(b)(4). Thus, if a state tax system uses federal adjusted gross income as its starting point, any reduction in the federal charitable deduction for state tax credits claimed on the state return will not affect the state computation.

¹³³ See *supra* note 130.

¹³⁴ See Brown, *supra* note 131 at 856 n.194 (listing the six states that permit deduction of federal taxes on state income tax returns).

¹³⁵ See Fiscal Facts., *Itemized Deductions*, TAX POL'Y CTR., Jan. 29, 2018, <https://www.taxpolicycenter.org/fiscal-fact/itemized-deductions-ff> (noting that 30% of taxpayers itemized in 2015 but under the TCJA, “the share is expected to be more than halved”).

¹³⁶ See Joseph Bankman, David Gamage, Jacob Goldin, Daniel Hemel, Darien Shanske, Kirk J. Stark, Dennis J. Ventry Jr., & Manoj Viswanathan, *Caveat IRS: Problems With Abandoning the Full Deduction Rule*, 88 ST. TAX NOTES 547, 551 (2018) (discussing problems associated with determining the value of a state tax deduction).

¹³⁷ Sections 263 and 1011 would treat the taxpayer as having purchased the state tax credits and would allow her a cost basis in them.

2. Income Inclusion Approach

Though several courts have held that the grant of a nonrefundable state tax credit does not create gross income, their holdings do not follow from the plain language of any statute. Thus, under the familiar *Chevron* and *Brand X* frameworks, the Service likely can issue regulations requiring that taxpayers include state tax credits in their gross incomes.¹³⁸ And if the Service adopted this approach, the charitable contribution strategy would fail. Any donation that allegedly established section 170 deductions would also create gross income, generally leaving the taxpayer no better off than had she not pursued the strategy.¹³⁹

Whether the Service *should* exercise its interpretive authority this way remains unclear. If the Service concluded that state tax credits create income under section 61, it could not fairly limit its regulation to only credits received through the charitable contribution strategy. Those credits, after all, may be indistinguishable from other state tax credits.¹⁴⁰ And if the Ser-

¹³⁸ See *Chevron*, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 843 (1984) (“[I]f the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency’s answer is based on a permissible construction of the statute.”); *Nat’l Cable & Telecomm. Ass’n v. Brand X Internet Servs.*, 545 U.S. 967, 982 (2005) (“[A] court’s prior judicial construction of a statute trumps an agency construction otherwise entitled to Chevron deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute.”).

¹³⁹ See, e.g., I.R.S. CCA 200238041 (Sept. 20, 2002) (When a taxpayer transfers property worth \$10,000 to a state, “if the \$10,000 section 170 deduction for the taxpayer in State B is offset by treating the \$10,000 refundable credit payment as ordinary income, the resulting offset cancels out the benefit of the charitable deduction.”).

¹⁴⁰ In the international tax context, foreign government credits are apparently excluded from income, and the recipient taxpayer will not be deemed to have made any tax payments. Cf. Treas. Reg. § 1.901-2(e)(2)(ii) (2013), Example 2. This exclusionary approach may be necessary given that a foreign tax payment, unlike a state tax payment, often allows the taxpayer a credit against his U.S. tax liability. See I.R.C. §§ 275(a)(4), 901(a) (allowing a taxpayer to elect a credit for some foreign taxes rather than a deduction). Under this framework, if the foreign government’s grant of a credit to a U.S. taxpayer caused him to recognize income, that taxpayer would also have a U.S. credit when he applied the foreign government credit against his foreign tax liability. This would leave the taxpayer ahead, because the U.S. tax liability associated with the additional income inclusion would be smaller than the benefit of the U.S. tax credit associated with the deemed payment. Thus, there are strong policy reasons for an exclusionary approach to foreign government credits. However, if a foreign government credit arose in a manner analogous to those that arise under the charitable contribution strategy, a taxpayer should

vice adopts a broad approach, many taxpayers may find themselves facing income inclusions and limited offsetting section 164 deductions.

However, because refundable credits generally give rise to income,¹⁴¹ it may be appropriate to extend similar treatment to nonrefundable credits, including those received under the charitable contribution strategy.¹⁴² In simple circumstances, after all, taxpayers who receive refundable credits and taxpayers who received nonrefundable credits may be in economically equivalent positions. Suppose, for example, that a taxpayer cashes out a \$100,000 refundable credit today and then uses those funds to pay her tax liability next year. On these facts, she will recognize income this year and enjoy a deduction (subject to the SALT deduction limit) next year. But the taxpayer who receives a nonrefundable \$100,000 credit this year and applies it to her tax liability next year will neither recognize income nor enjoy a deduction, even though she's in the same economic position as the first taxpayer. Arguably, tax regulations should treat each taxpayer similarly, and each taxpayer should recognize income in the first year.¹⁴³

One could plausibly respond that the tax law often treats taxpayers who receive cash differently from taxpayers who do not. Many provisions, for example, provide tax-free treatment when a taxpayer exchanges one piece of property for another piece of property.¹⁴⁴ Thus, the difference in tax treatment between refundable and nonrefundable state tax credits may follow from sound tax policy principles and may ease administrative burdens.

That line of reasoning would carry more force if taxpayers recognized income from refundable tax credits only when they were cashed out. But the Service has successfully advanced a different approach. In *Maines v. Commissioner*, the Tax Court held for the Service and concluded that an op-

be eligible for the section 901 credit, since he will have made an actual payment to the foreign government.

¹⁴¹ See *Ginsburg v. United States*, 136 Fed. Cl. 1 (2018) (taxpayer recognized income from cash received through a refundable state tax credit).

¹⁴² See I.R.S. Info. Ltr. 2013-0009 (Mar. 29, 2013) (summarizing administrative practices and rulings on refundable state tax credits); *Ginsburg*, 136 Fed. Cl. 1 (2018) (taxpayer recognized income from cash received through a refundable state tax credit).

¹⁴³ One might argue that rather than require recognition for each taxpayer, neither taxpayer should recognize income. In theory, this approach could work in a principled manner. But section 164 would need to be amended, and the tax benefit rule potentially expanded, to ensure that the cashing-out taxpayer does not enjoy a deduction when he applies his refunded amounts against his tax liability in a future year.

¹⁴⁴ See, e.g., I.R.C. § 1031 (providing nonrecognition treatment for some like-kind transactions).

tionally refundable credit created income even when the taxpayer elected no refund.¹⁴⁵

Maines involved three different New York state tax credits, including two that offered a partial refund feature. When those state tax credits exceeded the liability against which they could be applied, the taxpayer could immediately take a percentage of the excess credits in cash or apply them fully in a later year. The *Maines* taxpayers elected to wait.

The Service argued and the Tax Court held that the taxpayers recognized income.¹⁴⁶ The court emphasized that the taxpayers had a “clear right” to a partial refund, and there were “no limits” on their ability to receive that refund.¹⁴⁷ Thus, the taxpayers “constructively received income equal to what they *could* have received as a direct payment even if they in fact chose not to do so.”¹⁴⁸

This approach to refundable state tax credits establishes various administrative burdens. Determining the basis in these credits and the tax consequences on their later use presents potentially thorny questions.¹⁴⁹ Thus, whether or not the Service adopts an inclusionary approach to nonrefundable credits, it must wrestle with foundational income and deduction questions for refundable state tax credits.¹⁵⁰

Nonetheless the Service should not address broad questions on state tax credits through regulations on the charitable contribution strategy. Determining when to include state tax credits in income, and determining the tax

¹⁴⁵ *Maines v. Commissioner*, 144 T.C. 123 (2015).

¹⁴⁶ See *id.* at 136.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* (emphasis added).

¹⁴⁹ One Service memorandum contemplated that a taxpayer who constructively received a refundable New York real property state tax credit would “also be treated as having made a corresponding payment of state tax for that other tax year,” implying that any includible amount would be matched with a simultaneous deduction under I.R.C. § 164. See I.R.S. CCA 200842002 (Oct. 17, 2008). However, the authority the memo relies on, Rev. Rul. 71-190, 1971-1 C.B. 70 involved a situation where a state received an estimated tax payment and then credited that payment to “the taxpayers account prior to the close of its taxable year” such that the taxpayers had made “a bona fide payment of taxes within the meaning of I.R.C. § 164(a).” That is a materially different situation from one where a taxpayer constructively receives a credit and it remains unclear when or whether it will be applied against his state tax liability. On those facts, the case for an immediate I.R.C. § 164 deduction seems weak. In any event, various issues related to constructively received state tax credits remain open.

¹⁵⁰ Additionally, as noted in Part II.B, the basis on which the Service has excluded nonrefundable state tax credits from gross income has eroded. See *supra* notes 69–70 and accompanying text.

consequences on their use, demands an independent regulation project and possibly legislative involvement. Additionally, in some cases, state tax credits may qualify as excludable social welfare payments or gifts, and the Service can work with Congress to identify the proper criteria.¹⁵¹ For now, the Service should address the charitable contribution strategy through a substance over form approach.

3. Substance Over Form

Because Notice 2018-54 expressly refers to substance over form principles, any proposed regulations will probably apply those principles to the charitable contribution strategy. Under one potential approach, the Service could simply disregard a state's issuance of a tax credit and treat donations to state-controlled funds as tax payments under section 164. Under a second potential approach, the Service could treat the nominal donation to the state-controlled fund as a purchase of state tax credits. A section 164 deduction would arise when those credits were applied against the taxpayer's tax liability.

The first approach fits better with the Service's general approach to state tax credits.¹⁵² That is, the Service generally contends that no income arises from the receipt of a nonrefundable state tax credit, and a taxpayer enjoys no deduction when he applies that credit against his tax liability. In other words, for federal income tax purposes, the Service ignores the grant and use of a state tax credit. If the Service issues regulations providing that state tax credits will be disregarded under the charitable contribution strategy, the Service can continue to avoid attaching specific tax consequences to their grant and use.

Regulations issued under this first approach cannot be short – a one sentence statement that “substance prevails over form” will not provide adequate guidance to taxpayers. And the regulations cannot completely ignore state tax credits. For example, a state may provide that credits granted under its charitable contribution strategy may apply in a future year. In that case, the regulations should provide that, to the extent a nominal donation creates a credit that is not immediately used, that donation will be treated as

¹⁵¹ See I.R.S. CCA 200708003 (Feb. 23, 2007) (concluding that Minnesota military service credit, when refunded in cash, constituted a gift under I.R.C. § 102(a)) (relying on Rev. Rul. 68-158 (cash payments a state made to some U.S. veterans for their service in various conflicts were excludable as gifts)). See also I.R.S. Gen. Couns. Mem. 37,509 (Apr. 25, 1978) (advocating, contrary to the views of the Treasury, a return of capital theory towards a refundable state tax credit).

¹⁵² But see *supra* note 95.

a transfer analogous to a section 6603 deposit. Any section 164 deduction for taxes paid will then arise as the taxpayer applies her credits against her tax liability.¹⁵³

Regulations issued under this approach should also provide that only amounts nominally donated to a state-controlled fund may be re-characterized as taxes. After all, if a taxpayer donates to a charity or fund that has nothing to do with the state government, she cannot have paid a tax.¹⁵⁴ Governments, not charities, enjoy taxing authority. Donations to the American Red Cross are not taxes “imposed by a State” under section 164(b)(2).¹⁵⁵

Under the second approach, regulations could treat a taxpayer’s nominal donation under the charitable contribution strategy as a purchase of state tax credits. For example, when a taxpayer transfers \$100 to a state-controlled fund and receives \$85 in state tax credits, she will be deemed to have purchased those credits for their face value. The remaining \$15 of her transfer would generally be deductible under section 170.

Issuing regulations under this second approach may seem unappealing, because the Service would have to expressly consider the consequences associated with state tax credit transactions. But the case law mandates that inquiry. In *Maines v. Commissioner*, discussed earlier, the Tax Court followed the Service’s argument and held that a taxpayer recognizes income when he constructively receives refundable state tax credits.¹⁵⁶ Though the opinion does not deal with further consequences, a taxpayer would presumably have a basis in constructively received credits and would claim a section 164 deduction when applying them against his tax liability. Thus, the Service must already deal with taxpayers who report deductions when using state tax credits.

The second substance over form approach would be particularly attractive whenever transferable tax credits arise under the charitable contribution strategy. If a taxpayer receives those credits and later sells them, oddities would arise under the first approach because that approach ignores their existence. But the second substance over form approach would make the

¹⁵³ For Service procedures relating to deposits and their application against assessed federal tax liabilities, see Rev. Proc. 2005-18, 2005-13 I.R.B. 798.

¹⁵⁴ See Rev. Rul. 61-152, 1961-2 C.B. 42 (“A tax is an enforced contribution, exacted pursuant to legislative authority in the exercise of the taxing power.”) (quoting I.T. 3511, C.B. 1941-2, 90).

¹⁵⁵ See I.R.C. § 164(b)(2) (“A State or local tax includes only a tax imposed by a State, a possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia.”).

¹⁵⁶ 144 T.C. 123 (2015).

analysis relatively straightforward.¹⁵⁷ That approach properly recognizes that the use of a state tax credit may reflect the payment of a tax.

Either substance over form approach could present valuation issues, and some believe that those issues should discourage Service guidance.¹⁵⁸ Broadly speaking, state tax credits come in many forms and might not have a readily ascertainable fair market value. They may or may not be transferable, may or may not expire, may or may not be refundable, and so on. Thus, the Service will face administrative hurdles if it tries to value state tax credits or determine their basis.

That argument would apply to regulations that adopted an income inclusion approach for all state tax credits, but it does not apply to substance over form regulations addressed towards the charitable contribution strategy. By design, the strategy contemplates state tax credits that taxpayers will use. Otherwise, taxpayers will not participate. In regulations, the Service should advise taxpayers that credits from the charitable contribution strategy must be valued at their face amount.

But some taxpayers may never apply a purchased state tax credit against their tax liabilities. A purchased credit may have expired prior to its use or, contrary to the assumptions above, may face significant restrictions. Regulations may thus need to address the tax consequences related to state tax credits that are acquired and lost under the charitable contribution strategy. Section 165 would not seem to allow a loss deduction, but the Service might enjoy interpretive authority to conclude otherwise.¹⁵⁹

Under any substance over form approach, regulations should provide that a taxpayer's subjective motivations do not affect the section 164 analysis. If a taxpayer transfers funds to a state and the state applies those funds against her tax liability, she has paid a tax, even if she privately intended to make a donation. Unlike various other tax code provisions, section 164 does not refer to a taxpayer's intent.

¹⁵⁷ See *supra* note 109. See also Tempel v. Commissioner, 136 T.C. 341 (2011) (addressing tax consequences related to the sale of state tax credits).

¹⁵⁸ See Joseph Bankman et al., *supra* note 136 ("[S]tate charitable tax credits incorporate many different features that complicate the determination of the amount of the credit available to the taxpayer.").

¹⁵⁹ Cf. Alan L. Feld, Federal Taxation of State Tax Credits, 51 TAX NOTES 1243, 1245 (2016) ("The 'loss' created by using the credit against state income tax does not fit well within the statutory categories in section 165(c); it does not constitute a loss incurred in a trade or business or in a transaction entered into for profit, nor is it a casualty loss."). In suggesting that no deduction might arise from the application of a credit against state income tax, Feld overlooks section 164. But concerns over a loss-granting provision would apply to expired state tax credits.

The Service enjoys wide latitude when it issues regulations, and it is of course not bound by the substance over form approaches described here. However, these approaches allow the Service to avoid most of the complexities that arise under the *quid pro quo* and the income inclusion approaches. Thus, if the Service wishes to directly address the charitable contribution strategy, it should adopt a substance over form approach. Broader state tax credit issues may be pursued in a separate regulation project.

B. Should the Service Act

Given the potential revenue consequences associated with the charitable contribution strategy, the Service will likely finalize regulations addressing it. Under the TCJA, the new SALT deduction limit was intended to raise billions but if the charitable contribution strategy works, little might be raised.¹⁶⁰ Taxpayers could simply replace their nondeductible tax payments with deductible contributions and avoid the new limit. Some taxpayers might go even further and use the charitable contribution strategy to reduce their Alternative Minimum Tax liabilities. Others might obtain simultaneous deductions for state sales taxes. These additional maneuvers would cost the federal government potentially billions more. Thus, the Service should formally announce what existing law already shows: the charitable contribution strategy does not transform state tax payments into deductible contributions.

Some commentators, however, have expressed concerns that any attempt to address the charitable contribution strategy will disrupt programs established under the private credit model.¹⁶¹ Many states have long offered programs under that model and denying section 170 deductions could limit interest in them. Also, states have usually embraced private credit

¹⁶⁰ The Joint Committee on Taxation estimates that the TCJA's repeal or limits on personal itemized deductions would collectively save \$668.4 billion over 10 years. See STAFF OF JOINT COMM. ON TAXATION, 115 CONG. ESTIMATED BUDGET EFFECTS OF THE CONFERENCE AGREEMENT FOR H.R.1, THE "TAX CUTS AND JOBS ACT," at 2 (Comm. Print 2017). The JCT does not individually break down the revenue effects associated with the new SALT deduction limit, although states have noted the limit's significance. See N.Y. ST. DEP'T OF TAX'N AND FIN., PRELIMINARY REP. ON THE FED. TAX CUTS AND JOBS ACT (2018) ("Absent changes to New York's tax code, the [TCJA's] limitations on the deductibility of state and local taxes will cost New York's taxpayers an additional \$14.3 billion per year.").

¹⁶¹ See Daniel Rosen & David Pope, *Reversal of the Full Deduction Rule Would be Problematic*, 159 TAX NOTES 1333 (2018).

programs for reasons unconnected to federal tax avoidance, at least until recently.¹⁶²

Whatever the proper federal tax consequences under the private credit model might be, they need not be settled through regulations on the charitable contribution strategy.¹⁶³ If the Service follows a substance over form approach, only nominal donations made to state-controlled funds, not private charities, will qualify as taxes. One does not pay “taxes” to the American Red Cross or to a private school, and section 164 will not reach donations made to them.¹⁶⁴ A separate regulation project should address state tax credits that arise through those donations.¹⁶⁵

One might nonetheless argue that, as a policy matter, the tax law should not distinguish between donations to state-controlled funds and donations to private organizations. Private organizations often perform functions like those provided by the states, and it may seem arbitrary to treat differently the donations made to them. But whatever merit this argument might enjoy in the abstract, Congress has already addressed it by treating tax payments differently from charitable contributions.¹⁶⁶ The Service should respect this statutory framework and address transfers to states separately from transfers to private charities.¹⁶⁷

Some scholars believe that distinguishing between states and private charities would pose major administrative challenges.¹⁶⁸ But it is hard to

¹⁶² The new SALT deduction limit has created unanticipated benefits for many programs under the private credit model. States may have adopted that model for non-tax reasons, but those programs now provide another potential escape route from the SALT deduction limit. Some state officials have now discouraged Service guidance on tax credit programs. See, e.g., Georgia Lawmakers Request Better Targeting in Proposed SALT Regs, 82 EXEMPT ORG. TAX REV. 427 (2018).

¹⁶³ But see Carl Davis, *SALT/Charitable Workaround Credits Require a Broad Fix, Not a Narrow One*, INST. ON TAX'N & ECON. POL'Y (May 23, 2018) (arguing that Congress or the Service should broadly address state tax credit programs, and not only those involving the charitable contribution strategy), <https://itep.org/salt-charitable-workaround-credits-require-a-broad-fix-not-a-narrow-one/>.

¹⁶⁴ See *supra* notes 154–155 and accompanying text.

¹⁶⁵ See generally Amandeep S. Grewal, *The Proposed SALT Regulations May Be Doomed*, 103 IOWA L. REV. ONLINE 75, 82–87 (2018) (describing how *quid pro quo* principles apply differently to governmental and non-governmental recipients).

¹⁶⁶ Compare I.R.C. § 164(a) with I.R.C. § 170(a) & (c)(2).

¹⁶⁷ States and private charities receive similar treatment in the sense that transfers to either of them may be potentially eligible for the charitable contribution deduction. See I.R.C. § 170(c). However, the similar treatment under section 170(c) is not implicated by transfers to a state that are properly characterized as tax payments under section 164.

¹⁶⁸ See Bankman et al., *supra* note 136 at 555 (“[D]eveloping rules to guide taxpayer activity in this area would require the IRS to wade into a messy and fact-

understand why this is so. Many federal statutes refer to states, as does section 164 itself.¹⁶⁹ The Service and courts can thus draw on existing authorities to determine whether any given charitable fund belongs to a state or instead operates privately.¹⁷⁰

For example, when an organization properly enjoys a tax exemption under section 501(c)(3), any donations to that organization must automatically fall outside section 164. Section 501(c)(3) organizations engage in a statutorily restricted set of activities, narrower than those exercised by a state or a political subdivision.¹⁷¹ Section 501(c)(3) organizations thus cannot form an “integral part”¹⁷² of a state government and transfers to them will not qualify as taxes under section 164.¹⁷³

intensive set of questions” and applying new guidance under section 170 to only “gifts to ‘governmental’ entities would likely encourage parties to exploit (and enlarge) the already substantial overlap between and among the various types of non-profit entities.”). But it is highly doubtful that taxpayers could easily exploit the law in the manner suggested. The federal tax code offers important exclusions for States and their political subdivisions, see I.R.C. §§ 103, 115, and the relevant case law shows active enforcement efforts by the Service. *See Michigan v. United States*, 40 F.3d 817 (6th Cir. 1994) (unsuccessful Service challenge to the Michigan Education Trust’s status as a state political subdivision for purposes of the section 115(1) exclusion); Definition of Political Subdivision, 81 Fed. Reg. 8870-01 (Feb. 23, 2016) (opening a rulemaking project on political subdivisions under section 103 and summarizing prior law); BITTKER & LOKKEN, FED. TAX’N INCOME, EST.& GIFTS ¶ 102.10 (2018) (discussing court decisions and Service guidance on whether, under section 115, an organization constitutes part of a State or one of its political subdivisions).

¹⁶⁹ See I.R.C. § 164(b)(2).

¹⁷⁰ The relevant regulations adopt an “integral part” test. *See* Treas. Reg. § 301.7701-1(a)(3) (2011) (“[A]n organization wholly owned by a State is not recognized as a separate entity for federal tax purposes if it is an integral part of the State.”). *See also* BITTKER & LOKKEN, *supra* note 168 (“Whether an entity created by a state or local government is an ‘integral part’ of the government depends on such factors as whether the government has power to select and remove the entity’s governing body, to control the entity’s activities, investments, and expenditures, and to abolish the entity.”) (citing Rev. Rul. 87-2).

¹⁷¹ *See Uniband, Inc. v. Commissioner*, 140 T.C. 230, 256 (2013) (“Under section 501(c)(3), governance is not a tax-exempt purpose, so that while a mere ‘instrumentality’ of a State may be exempt from tax under that provision, an ‘integral part’ is not.”).

¹⁷² *See* Treas. Reg. § 301.7701-1(a)(3) (2011).

¹⁷³ *See* Rev. Rul. 2004-50, 2004-1 C.B. 977 (“A state or municipality itself, however, would not qualify as an organization described in section 501(c)(3) since its purposes are clearly not exclusively those described in section 501(c)(3) of the Code.”). For federal tax purposes, a section 501(c)(3) organization might be an instrumentality of a state but it would not qualify as the state itself or as one of its political subdivisions. *See also* *supra* note 171. Thus, neither section 164(b)(2) (refer-

If the Service delays guidance on the private credit model, states might rush to establish section 501(c)(3) organizations that will purportedly help their residents avoid the new SALT deduction limit.¹⁷⁴ However, the state would face risks from this. The section 501(c)(3) organization itself would not enjoy any benefits associated with state status and would face various filing and reporting requirements.¹⁷⁵

Probably to avoid those burdens, states that adopt the charitable contribution strategy usually require that the taxpayer's nominal donation go to the state or one of its political subdivisions.¹⁷⁶ Even when a state does not expressly do so, it may be obvious where a donation will end up. Connecticut, for example, enacted a version of the charitable contribution strategy under which a municipality may grant real property tax credits for dona-

ring to states and their political subdivisions) nor section 170(c)(1) (same) will reach transfers to a section 501(c)(3) organization. *But see* Bankman et al., *supra* note 136 at 554 (arguing that a section 501(c)(3) organization established by the South Carolina legislature would be treated as part of the South Carolina government under section 170(c)(1)). Bankman et al. also believe that *Route 231 v. Commissioner*, T.C. Memo. 2014-30, aff'd, 810 F.2d 247 (2016), involved a contribution to an organization that was a "political subdivision of the Commonwealth of Virginia." Bankman, et al., *supra* note 44 at 440. But it is highly doubtful that the recipient organization in that case, the Albemarle County Public Recreational Facilities Authority, so qualifies. The county itself does not manage that organization but appoints private citizens to do so. Nor does the organization exercise sovereign powers, such as through eminent domain. *See* VA. CODE ANN. § 10.1-1701 (describing authority for public bodies under the Open-Space Land Act, under which the Albemarle County Public Recreational Facilities Authority was established). *See also* Rev. Rul. 79-95, 1979-1 C.B. 331 ("The sovereign powers are the power of taxation, the power of eminent domain, and police or regulatory power. In order to qualify as a political subdivision, an entity need not possess all three powers, but what powers it does possess must be substantial in their effect.").

¹⁷⁴ See Rev. Rul. 60-384, 1960-2 C.B. 172 ("[A] wholly-owned state or municipal instrumentality which is a counterpart of an organization described in section 501(c)(3) of the Code such as a separately organized school, college, university, or hospital may qualify for exemption under section 501(c)(3) of the Code.").

¹⁷⁵ See, e.g., I.R.C. § 115(1) (providing exclusion for income derived from the "exercise of any essential governmental function and accruing to a State or any political subdivision thereof"). Section 501(c)(3) would grant a similar exclusion, but the organization would face various filing requirements. See, e.g., I.R.C. § 6033(a) and Treas. Reg. § 1.6033-2(a) (as amended in 2017). Also, the so-called unrelated business income tax usually does not apply to entities enjoying an exclusion under section 115. For an exception, see I.R.C. § 511(a)(2)(B) (applying the unrelated business income tax to state colleges and universities that enjoy the section 115 exclusion).

¹⁷⁶ See, e.g., 2018 Or. Laws S.B. No. 1528, § 4(1) (establishing charitable fund within the state treasury department).

tions to a specified private organization.¹⁷⁷ Though this looks like a program adopted under the private credit model, the statute requires that the private organization transfer donations received, less administrative expenses, to the municipality.¹⁷⁸ The municipality will then spend the donations and report on their use to the private organization.¹⁷⁹ Connecticut apparently believes that this arrangement precludes section 164 treatment for donated amounts. But a federal court would easily see that the taxpayer has, in substance, transferred funds to the municipality, not the private organization.¹⁸⁰

Line-drawing issues aside, some might argue that the charitable contribution strategy encourages tax compliance. If taxpayers can direct their tax dollars to specific funds, satisfaction with the tax system may increase. But that has nothing to do with whether the charitable contribution strategy allows taxpayers to avoid the SALT deduction limit. Whatever the Service does, states can provide their taxpayers with choice. Only improperly claimed federal tax benefits will be denied.

Some support for the charitable contribution strategy no doubt stems from purely political considerations. High tax, high services states typically vote Democratic, and those states lost the most through the new SALT deduction limit.¹⁸¹ Because the TCJA obtained exclusively Republican support, some persons in Democratic states believe that the new limit was meant to attack them.¹⁸²

¹⁷⁷ 2018 Conn. Pub. Acts 18-49, § 10(c) (municipality will specify single private organization to “receive cash donations that will qualify” for the real property tax credit).

¹⁷⁸ See *id.* (upon designating private organization to receive donations, municipality must enter into agreement with organization under which it will provide a grant to the municipality in an amount equal to all cash donations received, less administrative expenses up to 15%).

¹⁷⁹ See *id.* (municipality will provide a “written statement . . . of the municipal programs and services supported by such grant”).

¹⁸⁰ See *id.* (characterizing the municipality as the “administrative and fiscal agent” for the private organization). Although Connecticut controls characterizations under Connecticut law, under federal tax law, the private organization would be the agent for the municipality, not the other way around. The municipality, after all, selects the private organization to collect donations, and the municipality controls the expenditure of funds. See generally *Commissioner v. Bollinger*, 485 U.S. 340, 349 (1988) (discussing agency principles under federal tax law).

¹⁸¹ See *infra* notes 4 and 20–21.

¹⁸² See Jad Chamseddine, *No Standing to Sue Over SALT Cap, Federal Government Argues*, 2018 ST. TAX TODAY 215-1 (2018) (“The SALT cap has garnered many critics in blue states who have argued that the decision to cap how much individuals can deduct in state and local property taxes was a political hit job.”).

However, even if this is true, and the longstanding concerns with the SALT deduction did not motivate the new limit,¹⁸³ the charitable contribution strategy does not provide the appropriate solution. Taxpayers cannot violate the law whenever they contest the wisdom of a statutory amendment. And states should seek recourse through the national political process, not through encouraging their residents to claim improper federal tax deductions.

IV. CONCLUSION

Once again, the Service has found itself in the middle of a brutal political fight. Some Democratic states have, rightly or wrongly, taken strong offense at a tax bill that was passed and opposed along party lines. Thus, as is often the case, the Service will make some persons upset no matter what it does.

However, over the years, the Service has maintained focus on its core mission. Even during the heated period immediately following the TCJA's passage, the Service acted when necessary, issuing guidance to taxpayers who were unclear on whether property tax prepayments would establish current deductions.¹⁸⁴ Thus, the Service's announcement that it will address the charitable contribution strategy should come as no surprise.

The various weaknesses with that strategy mean that the Service can follow any of several different paths, especially if it proceeds through regulation. This article has argued that the Service should act narrowly and adopt a substance over form approach. Nonetheless, when one closely studies the federal tax treatment of state tax credits, various profound ambiguities emerge. One hopes that, after the Service addresses the charitable contribution strategy, it will act further and clarify this underappreciated and sometimes puzzling corner of the tax law.

¹⁸³ For discussions of the policy problems with the SALT deduction and some potential defenses, see Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes under the Federal Income Tax*, 82 VA. L. REV. 413 (1996), and Brian D. Galle, *Federal Fairness to State Taxpayers: Irrationality, Unfunded Mandates, and the “Salt” Deduction*, 106 MICH. L. REV. 805 (2008). See also Sammartino, et al., *supra* note 3 at 7 (“TPC estimates that about one-quarter of households will claim the SALT deduction on their 2017 tax return, with about two-thirds of the tax benefit from the deduction going to households with income of \$200,000 or more.”), http://www.taxpolicycenter.org/sites/default/files/publication/154006/the_effect_of_the_tcja_individual_income_tax_provisions_across_income_groups_and_across_states.pdf.

¹⁸⁴ I.R.S. News Release IR-2017-210 (Dec. 27, 2017).

