October 11, 2018

The Honorable Steven T. Mnuchin
Secretary of the Treasury
U.S. Department of the Treasury
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The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
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Washington, DC 20224

The Honorable David J. Kautter
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and submitted electronically with the Federal eRulemaking Portal at:
www.regulations.gov (IRS REG-112176-18)

Re: REG-112176-18 Proposed Section 170 Regulations

Dear Sirs:

On August 27, 2018, the U.S. Department of the Treasury and the Internal Revenue Service issued proposed regulations\(^1\) under section 170 of the Code\(^2\) (the “Proposed Regulations”). In the preamble to the Proposed Regulations, Treasury and the Service requested comments “on all aspects”\(^3\) of the Proposed Regulations. Baker & McKenzie LLP, on behalf of the Coalition for the Charitable Contribution Deduction (3CD),\(^4\) respectfully submits this letter in response to the request for comments.

3CD consists of local governments, including counties, cities, towns, villages, and school districts, in the states of New York and New Jersey, along with state and countywide professional and advocacy organizations. 3CD’s members each serve a significant number of residents whose individual financial circumstances will

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\(^2\) Unless otherwise noted, all “Code” and “section” references are to the Internal Revenue Code of 1986, as amended, and all “Treas. Reg. §” references are to the Treasury Regulations promulgated thereunder.

\(^3\) 83 Fed. Reg. at 43570.

\(^4\) 3CD’s membership is attached as Exhibit A.

Baker & McKenzie LLP is a member of Baker & McKenzie International, a Swiss Verein.
cause them to be adversely affected by the Proposed Regulations.\textsuperscript{5} Included are entities that established charitable funds prior to the issuance of the Proposed Regulations, entities in the process of establishing such funds when the Proposed Regulations were issued, and entities that are contemplating the establishment of such funds.

I. Summary

Should the Proposed Regulations be finalized in their current form, they will be challenged. In such a circumstance, a reviewing court will be called upon to determine whether they were promulgated with a clear statutory mandate and under the proper protocols, and whether they reflect reasoned decision-making.

As currently drafted, the Proposed Regulations satisfy none of these conditions:

- **First**, the Proposed Regulations lack statutory authority under section 170, and the 2017 amendments to itemized deductions for state and local taxes under section 164 provide no legal basis—express or implied—to make the changes proposed by Treasury.

- **Second**, the Proposed Regulations conflict with the current law treatment of state and local tax benefits. Under the Code, binding precedent, and longstanding published guidance, a state or local tax benefit reduces the amount of a taxpayer’s state or local tax liability. It is not a separate item of consideration, like an item of property.

- **Third**, the Proposed Regulations arbitrarily and capriciously treat state and local tax credits as having value solely for purposes of section 170 charitable contribution deductions, treating otherwise identically-situated taxpayers differently without a Congressional mandate or any other rationale for doing so.

- **Fourth**, the so-called “de minimis” exception under the Proposed Regulations lacks reasoned explanation, leads to results at odds with its stated goal of applying the *quid pro quo* doctrine to “substantial state or local tax benefits,” and results in divergent consequences for substantively identical circumstances.

\textsuperscript{5} Westchester County, a 3CD coalition member, estimates that 38 percent of its taxpayers, numbering 185,000 individuals, will be adversely affected by the Proposed Regulations.
• **Fifth,** the Proposed Regulations directly impact small entities, adding to their compliance burdens and affecting their capital raising efforts. As a result, Treasury was required to conduct a regulatory flexibility analysis to assess the scope and degree of the Proposed Regulations’ effects, yet failed to do so.

Accordingly, and for the reasons fully set forth below, the Proposed Regulations should be withdrawn.

**II. Background**

In May 2018, Treasury and the IRS announced their intention to address—in regulations—new state tax programs that allowed taxpayers to make donations to funds controlled by state or local governments (or other transferees specified by the state) in exchange for state or local tax credits. See Notice 2018-54, 2018-24 I.R.B 750. Their stated concern was that these programs enabled “taxpayers to characterize such transfers as fully deductible charitable contributions for federal income tax purposes, while using the same transfers to satisfy state or local tax liabilities.” Notice 2018-54 suggested that forthcoming regulations would not effect major changes in the law:

The proposed regulations will make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers. The proposed regulations will assist taxpayers in understanding the relationship between the federal charitable contribution deduction and the new statutory limitation on the deduction for state and local tax payments.

The Proposed Regulations bear no resemblance to those foreshadowed in Notice 2018-54. Notably, the Proposed Regulations do not address the effect of substance-over-form or other established legal principles. Instead, they announce a fundamental shift in how state and local tax credits supposedly factor into a *quid pro quo* analysis, with such shift applicable solely for purposes of section 170 and unmoored from any overriding principles of the tax law.
III. Discussion

a. The Proposed Regulations Lack Statutory Authority.

The 2017 amendments to itemized deductions for state and local taxes under section 164 provide no legal basis—express or implied—to make the changes proposed by Treasury. If Congress intended to articulate a new interpretation of the *quid pro quo* standard and upend the well-settled U.S. tax treatment of state and local tax credits, it would have done so. Instead, Treasury has read into the amendments a grant to unjustifiably extend its authority and upset settled law based on its own policy preferences.

The Proposed Regulations address concerns outside the scope of their purported statutory trigger. Public Law 115-97 added section 164(b)(6) to the Code. That provision limits an individual’s deduction for the aggregate amount of state and local taxes paid during the calendar year to $10,000 ($5,000 in the case of a married individual filing a separate return). The statutory language and legislative history to section 164(b)(6) are unremarkable: both merely state how the provision operates. Importantly, neither directs Treasury and the IRS to issue regulations addressing any alleged “gaps” in either section 164 or section 170. Congress’ silence is not surprising: section 164(b)(6) is mechanical and requires no supplemental explanation. Likewise, Public Law 115-97 made no relevant changes to section 170, the provision to which the Proposed Regulations now purportedly attach.

Congress would have been keenly aware of the purported *quid pro quo* concern when Public Law 115-97 was enacted. As the Preamble recognizes, state and local tax credit programs were widespread in the years prior to the enactment of Public Law 115-97. Moreover, these pre-existing programs have been the subject of much public commentary, demonstrating how they work around the Alternative Minimum Tax (“AMT”) cap on the deductibility of state and local taxes. For example:

Many scholarship organizations have realized that the profit-generating opportunities… may appeal to donors that would not otherwise be interested in giving to private schools. One organization based in Georgia, for example, brags to potential

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6 See 83 Fed. Reg. at 43564 (“In recent years, it has become increasingly common for states and localities to provide state or local tax credits in return for contributions by taxpayers to or for the use of certain entities listed in section 170(c).”).
donors that “you will end with more money than when you started”[.]. Similarly, a tax lawyer in Alabama notes on her firm’s website that for taxpayers subject to the AMT, “donating” will actually “put money in your pocket.”

Carl Davis, State Tax Subsidies for Private K-12 Education, Institute on Taxation & Economic Policy, Oct. 2016, at 7, available at https://itep.org/wp-content/uploads/k12taxsubsidies-1.pdf (fn. ref. omitted); see id. at 8 (“For taxpayers subject to the federal Alternative Minimum Tax (AMT), federal charitable deductions are typically the most lucrative tax benefit that can be stacked on top of state scholarship tax credits.”); see also Phillip Blackman and Kirk J. Stark, Capturing Federal Dollars With State Charitable Tax Credits, Tax Notes (Apr. 1, 2013).

Notwithstanding that the purported quid pro quo concern was apparent under the AMT and would be heightened by the changes to section 164 made by Public Law 115-97 amendments, Congress was silent as to section 170 and as to the interaction between the two provisions.

b. The Proposed Regulations Conflict with Current Law Treatment of State and Local Tax Benefits.

Under the Code, a state or local tax benefit reduces the amount of a taxpayer’s state or local tax liability. It is not a separate item of consideration, like an item of property. A longstanding IRS revenue ruling illustrates this basic principle. In Rev. Rul. 79-315, 1979-2 C.B. 27, the IRS addressed the effect that a state income tax rebate had on the federal deduction for state and local taxes. The IRS ruled that the portion of the tax rebate that was “credited against [state] tax due” is “treated as a reduction of the outstanding [tax] liability” and therefore that the tax prior to such a rebate is not “deductible under section 164(a)(3) of the Code as a state income tax paid.” Id.

This 1979 IRS guidance was followed in a series of administrative pronouncements in which the IRS Office of Chief Counsel specifically concluded that the receipt of state tax credits in return for contributions was a reduction in

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7 A copy is attached as Exhibit B.
8 A copy is attached as Exhibit C.
9 See Reuven Avi-Yonah et al., The Games They Will Play: Tax Games, Roadblocks, and Glitches under the House and Senate Tax Bills (2017), available at https://ssrn.com/abstract=3084187. A copy is attached as Exhibit D.
10 An exception to this rule, not applicable here, is where a tax benefit is offered in connection with the taxpayer performing an activity that is economically distinct from the activity being taxed. See Consolidated Edison Co. of New York, Inc. v. United States, 10 F.3d 68 (2d Cir. 1993).
the amount of state and local tax paid and deductible under section 164, and not a quid pro quo that would affect the amount of a taxpayer’s charitable contribution deduction under section 170(a). See, e.g., CCA 201105010 (Oct. 27, 2010) (holding that “a state or local tax benefit is treated for federal tax purposes as a reduction or potential reduction in tax liability. As such, it is reflected in a reduced deduction for the payment of state or local tax under § 164, not as consideration that might constitute a quid pro quo, for purposes of § 170. . . .”) (citing Rev. Rul. 79-315).

Courts considering the U.S. tax treatment of state and local tax benefits have uniformly followed the IRS’s position. Maines v. Commissioner, 144 T.C. 123 (2015) (holding that a non-refundable portion of a state tax credit applied to decrease state income taxes and was not an “accession to wealth”); Tempel v. Commissioner, 136 T.C. 341 (2011) (“Respondent contends and petitioners do not contend otherwise that petitioners’ receipt of State tax credits as a result of their conservation easement contribution was neither a sale or exchange of the easement nor a quid pro quo transaction…. The parties and this Court agree that the receipt of a State tax credit is not an accession to wealth that results in income.”), aff’d sub nom. Esgrar Corp. v. Commissioner, 744 F.3d 648 (10th Cir. 2014); Route 231, LLC v. Commissioner, T.C. Memo. 2014-30 (accepting that a charitable contribution deduction was not offset by the receipt of state tax credits), aff’d, 810 F.3d 247 (4th Cir. 2016); SWF Real Estate, LLC v. Commissioner, T.C. Memo. 2015-63 (same). To the extent that there were any statutory gaps to fill, these cases closed them: the judicial consensus is that state and local tax credits provide no value in a quid pro quo evaluation.11 There is, therefore, no interpretive wiggle room within which Treasury can insert its desired result.

The Preamble disregards these cases and administrative guidance as effectively overruled by the purported impact of the 2017 amendments to itemized deductions for state and local taxes under section 164 and an “increased interest” in state tax credit programs. See 83 Fed. Reg. at 43564 (“In light of the tax consequences of section 164(b)(6) and the resulting increased interest in preexisting and new state tax credit programs, the Treasury Department and the IRS determined that it was appropriate to review the question of whether amounts paid or property transferred in exchange for state or local tax credits are fully deductible as charitable contributions under section 170”). This is not the kind of legal analysis necessary to explain an agency rule, much less one that changes an agency’s longstanding position. It is simply a policy conclusion that, in Treasury’s view, Congress should have changed section 170 when it changed section 164. The problem, of course, is that Congress didn’t.

Critically, the 2017 amendments to itemized deductions for state and local taxes under section 164 did nothing to change the relevant underlying tax law principles. They merely provide a reduction to the state and local tax amounts that taxpayers may deduct on their returns. There is no indication Congress did anything more than that. Nonetheless, the Proposed Regulations attempt to use this otherwise mechanical change as a justification, under a different provision of the Code (section 170), to effect a fundamental change in tax law principles. But tax law principles, such as the value, if any, of state tax credits, cannot vary or be reversed without express Congressional approval. To the extent that the 2017 amendments to itemized deductions for state and local taxes under section 164 require a change in these principles to make other sections of the Code complementary, that is the role of Congress, not Treasury.

c. **The Proposed Regulations Arbitrarily and Capriciously Treat State and Local Tax Credits as Having Value Solely For Purposes of Charitable Contribution Deductions.**

The Preamble acknowledges that the Proposed Regulations would now treat the receipt of state and local tax credits differently for purposes of section 170 than for other provisions of the Code, but provides no reasoned explanation for why this should be. The Preamble (83 Fed. Reg. at 43564) simply states that “the application of sections 61 and 1001 to state or local tax credits presents different issues than the application of section 170.” Those supposedly “different issues” are neither identified nor explained.

Sections 170 and 164 indeed present different issues – one considers a deduction for a charitable contribution and another a deduction for state taxes. The relevant legal question, however, is whether there is a reasoned basis for treating the same state or local tax credit as having value for one purpose of the Code (section 170) but not for any of the others (sections 61, 162, and 1001). There is not. Yet that is exactly what Treasury and the IRS have purported to do. *See IRS News Release IR-2018-178 (Sept. 5, 2018) (“clarify[ing]” that “[b]usiness taxpayers who make business-related payments to charities or government entities for which the taxpayers receive state or local tax credits can generally deduct the payments as business expenses [under section 162].”); 12 Treasury Secretary Mnuchin Statement on Clarification for Business Taxpayers: Contributions Under State and Local Tax Credit Programs Generally Deductible as Business Expenses (Sept. 5, 2018) (“The IRS clarification makes clear that the longstanding rule allowing businesses to deduct payments to charities as business expenses remains unchanged under the Tax Cuts and Jobs Act. The recent proposed rule

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12 A copy is attached as Exhibit E.
concerning the cap on state and local tax deductions has no impact on federal tax benefits for business-related donations to school choice programs.”),\(^{13}\) accord State and Local Income Tax FAQ, available at https://www.irs.gov/newsroom/state-and-local-income-tax-faq (last accessed Oct. 10, 2018).\(^{14}\)

The Proposed Regulations would thus treat otherwise identically-situated taxpayers differently without a Congressional mandate or any other rationale for doing so:

**Example 1:** A, a wage earner with $100,000 in adjusted gross income, makes a $10,000 contribution to a state charitable fund. In return, A expects to receive a state income tax credit of $5,000.

**Example 2:** B, self employed with $100,000 in adjusted gross income, makes a $10,000 contribution to the same state charitable fund as A as part of his or her business. In return, B expects to receive a state income tax credit of $5,000.

In Example 1, A, as a wage earner, can only deduct $5,000 as a charitable contribution under section 170, as the $5,000 state tax credit is treated as a *quid pro quo* reduction. In Example 2, however, B, as a self employed business person, can deduct the full $10,000 as a business expense under section 162, without either reducing the amount of that deduction by the amount of the $5,000 state income tax credit or including that amount in income under section 61 as consideration. The Proposed Regulations offer no explanation for such an arbitrary and capricious result, let alone a reasoned one.

**d. The De Minimis Exception Lacks Reasoned Explanation, and Leads to Arbitrary and Capricious Results.**

The Proposed Regulations set forth a so-called “*de minimis*” exception. If it applies, this exception disregards the general rule reducing the charitable contribution deduction dollar-for-dollar by the amount of the state or local tax credit and also exempts state and local tax credits that do not exceed 15 percent of the contribution.\(^{15}\)

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\(^{13}\) A copy is attached as Exhibit F.

\(^{14}\) A copy is attached as Exhibit G.

\(^{15}\) According to the Preamble, 15 percent reflects the highest combined state and local marginal tax rate. 83 Fed. Reg. at 43565.
The Preamble asserts several justifications for this exception. First, it asserts that “[b]ecause the benefit of a dollar-for-dollar deduction is limited to the taxpayer’s state and local marginal rate, the risk of deductions being used to circumvent section 164(b)(6) is comparatively low.” 83 Fed. Reg. at 43565. The Preamble provides no evidence to support this conclusion. Moreover, and even assuming such support, there is no basis for concluding that Congress intended that circumvention of section 164(b)(6) was a factor Treasury could rely upon in determining whether a quid pro quo exists for purposes of section 170. As discussed above, Congress made no relevant changes to section 170 in the legislation.

The Preamble next asserts that “if state and local tax deductions for charitable contributions were treated as quid pro quo benefits, it would make the accurate calculation of federal taxes and state and local taxes difficult for both taxpayers and the IRS. For example, the value of a deduction could vary based on the taxpayer’s marginal or effective state and local tax rates, making for more complex computations and adding to administrative and taxpayer burden.” 83 Fed. Reg. at 43565. Notwithstanding this rationale, the Proposed Regulations inconsistently require that a taxpayer treat state and local tax deductions that exceed the amount of the taxpayer’s payment or the fair market value of the property transferred as a quid pro quo benefit, which raises the same administrative and taxpayer burden Treasury relies upon for justifying the de minimis rule.

In addition to lacking any reasoned explanation, the de minimis rule leads to results at odds with its stated goal of applying the quid pro quo doctrine to “substantial state or local tax benefits.” 83 Fed. Reg. at 43565. As stated above, the de minimis rule applies to any state or local tax credit that is 15 percent or less than the value of the contribution. This percentage-base definition leads to arbitrary and capricious results, as illustrated by the following examples:

**Example 3:** A contributes $100,000 to a municipal charitable fund in State X, which entitles A to $15,000 in municipal property tax credits.

**Example 4:** B contributes $10,000 to a municipal charitable fund, in State Y, which entitles B to $1,600 in municipal property tax credits.

In Example 3, A is entitled to claim a $100,000 charitable contribution deduction, because the $15,000 in municipal property tax credits is de minimis. In Example 4, however, B is entitled to only claim a $8,400 charitable contribution deduction, notwithstanding that the only distinction between the two examples is a one
percentage point difference. Moreover, and more importantly for something called a *de minimis* rule, the Proposed Regulations treat $1,600 as not *de minimis*, yet treat an amount nearly 10 times greater, $15,000, as *de minimis*. As stated above, the Preamble justifies the *de minimis* rule as a basis to apply the “quid pro quo doctrine to substantial state or local tax benefits,” and yet the application of that rule runs directly counter to that justification. If $1,600 is “substantial” then so is $15,000.

Moreover, the *de minimis* rule operates separately from Treas. Reg. § 1.170A-1(h)(2), which limits deductions based on the amount of goods or property received. This too results in divergent consequences for substantively similar circumstances, as illustrated by the following examples:

**Example 5:** A contributes $10,000 to a section 501(c)(3) charitable organization, and receives tickets to a charity gala valued at $1,500.

**Example 6:** B contributes $10,000 to a state’s school choice fund, and receives $1,500 in state tax credits.

In Example 5, A can only deduct $8,500 because the tax attribute is reduced, dollar-for-dollar, by the fair market value of the property she received in consideration pursuant to Treas. Reg. § 1.170A-1(h)(2). However, in Example 6, B is not restricted by the consideration rules, because B received state tax credits, not charity gala tickets, and can therefore deduct the entire $10,000 contribution.

The Proposed Regulations provide no justification for these arbitrary and capricious results either. If the receipt of a state or local tax credit can be excused from being treated as a *quid pro quo* under the *de minimis* rule, then any other *quid pro quo* for purposes of section 170 should be treated in the same manner.

e. **Treasury is Required to Conduct a Regulatory Flexibility Analysis of the Proposed Regulations.**

Given their focus, the Proposed Regulations will directly impact small entities, adding to their compliance burdens and affecting their capital raising efforts. Accordingly, Treasury is required to conduct a regulatory flexibility analysis to assess the scope and degree of the Proposed Regulations’ effects.

Congress enacted the Regulatory Flexibility Act, 5 U.S.C. §§ 601-612 (“RFA”), to reduce the regulatory burden on small entities. Under the RFA, if a proposed regulation “is likely to have a significant economic impact on a substantial
number of small entities,” the agency is required to consider alternatives to the proposed regulation that would accomplish the same objectives without unduly burdening small entities. In considering alternatives, the RFA requires agencies to conduct economic impact analyses and describe alternatives that consider tiered application of rules, simplification, performance rather than design standards, and exemptions.

On August 13, 2002, President George W. Bush issued Executive Order 13272, requiring each agency to establish procedures and policies to promote compliance with the RFA. In 2003, Treasury issued an Attachment to Treasury Directive 28-01, titled “Department of the Treasury Policy and Procedures to Ensure Consideration of Potential Impacts of Regulations on Small Businesses and Entities,” articulating Treasury policy regarding E.O. 13272 and the RFA. It provides that Treasury should “[s]eek to minimize, consistent with statutory requirements and sound regulatory policy, the compliance and paperwork burdens of all their regulations on small entities. Small entities include small entities, small not-for-profit enterprises, and small governmental jurisdictions.” E.O. 13272 is still in effect.

Yet, notwithstanding the plain terms of the RSA and Treasury’s purported policy emphasis on relieving small entities’ burdens, no regulatory flexibility analysis was prepared for the Proposed Regulations:

The Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply because the proposed regulations primarily affect individuals and do not impose costs, including a collection of information, on small entities.

Treasury’s assertion that the Proposed Regulations primarily impact individuals and do not impose costs on small entities is plainly incorrect. The recipients of the charitable contributions impacted by the Proposed Regulations include small municipalities and school districts. In New York, for example, school districts and small municipalities are authorized to establish charitable funds to receive unrestricted charitable monetary donations. These school districts and small municipalities may provide for a real property tax credit for contributions to such funds, in an amount up to 95 percent of the contribution. The Proposed

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18 5 U.S.C. § 603(c).
19 Treasury Directive 28-01 was cancelled on February 7, 2017. See https://www.treasury.gov/about/role-of-treasury/orders-directives/Pages/td28-01.aspx. However, the IRS still endorses its guidance in promulgating regulations. See I.R.M. Part 32.1.5.4.7.5.4 (Aug. 21, 2018) (Regulatory Flexibility Act).
20 83 Fed. Reg. at 43570.
Regulations, however, chill such contributions by reducing a taxpayer’s charitable contribution deduction by the amount of real property tax credits received.

Indeed, the Proposed Regulations are already having an *in terrorem* effect, imposing real costs on small entities in New York State. For example, the Village of Rye Brook’s charitable fund collected contributions prior to the issuance of the Proposed Regulations, but those contributions stopped once the Proposed Regulations were issued, and Ithaca’s charitable fund has received no contributions. Small entities in other states face similar costs under the Proposed Regulations.

For all of the reasons described above, the Proposed Regulations are not the product of reasoned decision-making, are arbitrary and capricious, and should properly be withdrawn.

Respectfully submitted,

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Attachments

cc: Tom West, Tax Legislative Counsel, U.S. Department of the Treasury

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21 See Jimmy Vielkind, *New York Towns Gearing Up to Fight IRS Ruling on Local Taxes*, THE WALL STREET JOURNAL (Sept. 30, 2018) (“Fourteen New York municipalities have set up the charitable funds, according to a database of local laws and interviews with municipal officials . . . [b]ut the IRS ruling in August that declared the charitable-donation structure unlawful has had a chilling effect, according to Gerry Geist, executive director of the state’s Association of Towns and a member of the coalition.”).

22 See Emma Beyer, *Private Schools Could Take Unintended Hit From IRS Donation Regs*, BNA DAILY TAX REPORT (Oct. 5, 2018) (“[P]rivate schools [in states including Louisiana, Georgia, and South Carolina] are scrambling to figure out what to do if they lose millions of dollars in donations due to the proposed regulations.”).
Coalition for the Charitable Contribution Deduction

Association of School Business Officials of New York
Association of Towns of the State of New York
New York Conference of Mayors
New York State Association of Counties
New York State Council of School Superintendents
New York State School Boards Association
Westchester Putnam School Boards Association
   Nassau County
   Suffolk County
   Westchester County
   City of New Rochelle
   City of White Plains
   City of Yonkers
   Town of Bedford
   Town of Lewisboro
   Town of Mamaroneck
   Town of New Castle
   Town of North Salem
   Town of Ossining
   Town of Pelham
   Town of Rye
   Village of Ardsley
   Village of Hastings-on-Hudson
   Village of Pelham
   Village of Pelham Manor
   Village of Scarsdale
   Village of Upper Brookville
   Ardsley Union Free School District
   Brewster Central School District
   Briarcliff Manor Union Free School District*
   Byram Hills Central School District
   City School District of New Rochelle
   Dobbs Ferry Union Free School District
   Eastchester Union Free School District
   Edgemont Union Free School District
   Hastings-on-Hudson Union Free School District
   Katonah-Lewisboro School District
   Ossining Union Free School District
   Pelham Public Schools
   Pleasantville Union Free School District
   Pocantico Hills Central School District
   Public Schools of the Tarrytowns
   White Plains City School District**
* Briarcliff Manor Union Free School District’s participation has been provisionally authorized by the Superintendent, pending a ratifying vote of approval by the Board of Education on October 11.

** White Plains City School District’s participation has been provisionally authorized by the Superintendent of Schools, pending a ratifying vote of approval by the Board of Education on October 15.
State Tax Subsidies for Private K-12 Education

Institute on Taxation & Economic Policy

October 2016 (with updates from May 2017)

Carl Davis

About The Institute on Taxation & Economic Policy

The Institute on Taxation and Economic Policy (ITEP) is a non-profit, non-partisan research organization that works on federal, state, and local tax policy issues. ITEP's mission is to ensure that elected officials, the media, and the general public have access to accurate, timely, and straightforward information that allows them to understand the effects of current and proposed tax policies. ITEP's work focuses particularly on issues of tax fairness and sustainability.
INTRODUCTION

One of the most important functions of government is to maintain a high-quality public education system. In many states, however, this objective is being undermined by tax credits and deductions that redirect public dollars for K-12 education toward private schools. Twenty states currently divert a total of over $1 billion per year toward private schools via special tax credits and deductions. These tax subsidies are essentially backdoor voucher programs, or "neovouchers," as they use the tax code to provide what amount to private school vouchers even when traditional voucher programs are unpopular with the public or outright unconstitutional.

Because of the ways that state and federal tax law interact, the subsidies offered in nine of these states turn the concept of a charitable "donation" on its head by offering upper-income taxpayers a risk-free profit on contributions they make to fund private school scholarships. In these cases, even taxpayers who would not ordinarily be interested in contributing to private schools may find the incentive too strong to ignore. Some states have seen an entire year's allotment of tax credits claimed within days, or even hours, of being made available as wealthy taxpayers seek to capture their share of the profits associated with convoluted "neovoucher" systems. In effect, states that have encountered political or constitutional obstacles to spending public dollars on private schools have instead set up a system that allows wealthy taxpayers to enjoy a profit by facilitating such spending on the state's behalf.

This report explains the workings, and problems, with state-level tax subsidies for private K-12 education. It also discusses how the Internal Revenue Service (IRS) has exacerbated some of these problems by allowing taxpayers to claim federal charitable deductions even on private school contributions that were not truly charitable in nature. Finally, an appendix to this report provides additional detail on the specific K-12 private school tax subsidies made available by each state.

TYPES OF TAX CREDITS AND DEDUCTIONS

State-level tax provisions designed to subsidize private schools typically fall into one of two categories: those designed to facilitate the granting of private school scholarships, and those designed to offset private school expenses for families with children enrolled in such schools.

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1 ITEP calculation using data compiled in the appendix of this report.
Tax subsidies for private school scholarships

The most common, and most costly, tax subsidies for private education are intended to encourage businesses and/or individuals to contribute to organizations that distribute private school scholarships to qualifying students. Seventeen states offer tax credits designed to accomplish this purpose (see Figure 1), and their design varies considerably by state:

- Sixteen states offer nonrefundable scholarship credits, with some of these limited to a certain percentage of tax liability. In Georgia, for example, the scholarship credit cannot be used to offset more than 75 percent of income tax liability in a given year. Many of these credits can be “carried forward,” however, meaning that if a taxpayer does not owe enough tax to be able to use the credit this year, they can opt to claim some or all of the credit in later years. Louisiana is the only state where the scholarship credit is refundable—actually administered as a rebate—and therefore not tied to tax liability in any way.

- Scholarship tax credits range from 50 percent of the contribution amount (Indiana and Oklahoma) to 100 percent of the total contribution (Alabama, Arizona, Florida, Georgia, Montana, Nevada, and South Carolina). Credits equal to 100 percent of the contribution are designed to allow taxpayers to redirect their tax payments toward private institutions at no cost to themselves. In practice, the actual tax benefits for credit recipients can sometimes even exceed the size of the donation.

When the impact of state tax credits is combined with federal tax deductions (and sometimes state tax deductions as well), some taxpayers can actually turn a profit by making these so-called “donations”—an outcome described in detail below.

Figure 1: State Tax Credits and Deductions for Private K-12 Education

<table>
<thead>
<tr>
<th>State</th>
<th>Private School Scholarship</th>
<th>Private School Tuition and/or Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Number of States</td>
<td>17</td>
<td>8</td>
</tr>
<tr>
<td>with Refundable Credit (RC)</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>with Nonrefundable Credit (NC)</td>
<td>16</td>
<td>2</td>
</tr>
<tr>
<td>with Deduction (D)</td>
<td>0</td>
<td>4</td>
</tr>
</tbody>
</table>

Source: Institute on Taxation and Economic Policy (ITEP)
Of the seventeen states that offer a scholarship credit, seven states only extend their credits and deductions to businesses (Florida, Kansas, Nevada, New Hampshire, Pennsylvania, Rhode Island, and South Dakota). Notably, four of these states do not levy personal income taxes. Among the ten states that allow both businesses and individuals to claim scholarship credits, four states (Arizona, Georgia, Oklahoma, and Virginia) allow businesses to claim a larger credit than individual taxpayers.

While the scholarships funded by many of these tax credits are limited to low- or middle-income families, states such as Arizona, Georgia, and Montana offer at least some of the scholarships with no income restrictions.

Some states place further limits on scholarship eligibility beyond income level, such as Pennsylvania where students must live in a "low-achieving" school zone and Kansas where students over six years of age must have been enrolled in a public school during the previous school year. These requirements have not always been strictly enforced, however, such as when the Georgia Department of Education signed off on parents "enrolling" their children in public schools to gain eligibility for the scholarship program, despite having no intention of allowing their children to attend the public schools in which they enrolled.³

Aggregate limits on the size of these credits vary widely. Oklahoma's credit is capped at just $3.4 million, for example, while Florida's cap is set at almost $700 million for Fiscal Year 2018.⁴

**Tax subsidies for private school tuition and/or expenses**

Eight states offer tax credits or deductions to individuals to defray the cost of attending a private school (see Figure 1). The design of these tax subsidies varies considerably across states:

- Four states structure their subsidies as deductions, while five states offer tax credits (Minnesota offers both). Tax credit design also varies by state, with Illinois and Iowa allowing only "nonrefundable" credits that can offset, but not exceed, the taxpayer's income tax bill. Alabama, Minnesota, and South Carolina offer "refundable" credits that are not dependent on earning enough to owe income tax.

- The private school expenses that qualify for the tax subsidy vary by state. Wisconsin's deduction is limited to private school tuition, for example, while Indiana applies its deduction much more broadly to include not just tuition but also textbooks, fees, software, tutoring, and school supplies. Minnesota offers a deduction for both tuition and expenses, as well as a refundable credit that can only be applied against non-tuition expenses.

- Most state tax subsidies for private school expenses are available to all families regardless of income level or other characteristics. In South Carolina, however, the credit is only available to families with exceptional needs children. In Alabama the benefit is only available for children enrolled in a public school judged to be "failing." And in Minnesota, the credit portion of the subsidy begins phasing out for families with incomes above $33,500.


• Each state uses a different formula for calculating the subsidy and imposes different limits on the size of the subsidy. Deductions range in size from $1,000 per dependent in Indiana to $10,000 per dependent (grades 9-12) in Wisconsin. Tax credits vary significantly as well, with more generous credits confined to states such as Alabama and South Carolina that, as mentioned above, only allow a small subset of students to claim them. The broader credits made available to all, or most, private school students vary from a maximum of $250 per dependent in Illinois and Iowa to $1,000 per dependent in Minnesota.

SUBSIDIES RUN AMOK: PROFITING FROM SCHOLARSHIP "DONATIONS"

In 2011, the IRS issued a memo indicating that taxpayers can claim a federal charitable deduction for private school scholarship donations even when those donations are also subsidized with a state tax credit. While the memo states that it “may not be used or cited as precedent,” scholarship organizations in over a dozen states have been advising their donors that their contributions are eligible for a federal tax deduction in addition to a state tax credit. For some high-income taxpayers, this dual benefit can turn a scholarship “donation” into a profit-generating scheme where the total tax cut received significantly exceeds the size of the original donation. It should therefore come as little surprise that in some states, the entire allotment of available credits is often claimed just hours after state tax officials begin accepting applications.

A close look at South Carolina’s scholarship tax credit illustrates how this works. In the Palmetto State, taxpayers receive a dollar-for-dollar tax credit for any “donations” they make to certain nonprofit scholarship funding organizations—thereby making the donation essentially costless to the taxpayer. Assuming the taxpayer itemizes on their federal return, the immediate federal tax consequence of a donation is twofold: the taxpayer’s charitable deductions increase by the amount of the donation, and the taxpayer’s state income tax deduction falls by the amount of the tax credit they received. At first, this may appear to result in a wash for the taxpayer. But this is not always the case because in some instances, charitable deductions are more valuable than deductions for state income taxes paid.

At the federal level, one of these instances arises when taxpayers are subject to the individual Alternative Minimum Tax (AMT). The AMT is designed to ensure that taxpayers receiving generous tax breaks pay at least some minimum level of federal income tax. This is accomplished by denying certain tax breaks under AMT rules, including the deduction for state and local tax payments. Charitable donations, however, are still tax deductible under the AMT. So the ability to reclassify state income tax payments as charitable donations via a scholarship tax credit can be of significant benefit to taxpayers subject to the federal AMT—a group overwhelmingly comprised of taxpayers earning over $200,000 per year.

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6 An ITEP review found scholarship organizations advising donors that they can claim the federal charitable deduction in addition to state tax credits in Alabama, Arizona, Georgia, Indiana, Iowa, Louisiana, Montana, New Hampshire, Oklahoma, Pennsylvania, Rhode Island, South Carolina, and Virginia.

7 The corporate AMT faced by C corporations does not allow for the same type of gaming described in this report.

8 IRS Statistics of Income data for Tax Year 2014 indicate that 82 percent of returns owing AMT, and 93 percent of dollar raised via the AMT, are associated with this group. Taxpayers earning between $200,000 and $500,000 per year are most likely to be affected by the AMT, with 61 percent of
### Figure 2: Potential Profits from "Donations" to Scholarship Organizations

<table>
<thead>
<tr>
<th>State</th>
<th>Type of Taxpayer (Individual or Business)</th>
<th>Maximum Donation Eligible for Credit</th>
<th>Credit Percentage</th>
<th>Taxpayer Facing 35% Marginal Federal AMT Rate (inside AMT phase-out)</th>
<th>Potential Profit on Maximum Donation</th>
<th>% Profit on Maximum Donation</th>
<th>Taxpayer Facing 28% Marginal Federal AMT Rate</th>
<th>Potential Profit on Maximum Donation</th>
<th>% Profit on Maximum Donation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>Both</td>
<td>$50,000</td>
<td>100%</td>
<td>$16,625</td>
<td>33%</td>
<td></td>
<td>$13,300</td>
<td>27%</td>
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<tr>
<td>Arizona</td>
<td>Individual</td>
<td>$2,173</td>
<td>100%</td>
<td>$662</td>
<td>30%</td>
<td></td>
<td>$510</td>
<td>23%</td>
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<tr>
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<td>Unlimited</td>
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<td></td>
<td>$550</td>
<td>23%</td>
<td></td>
</tr>
<tr>
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<td>Individual</td>
<td>$2,500</td>
<td>100%</td>
<td>$2,900</td>
<td>29%</td>
<td></td>
<td>$2,200</td>
<td>22%</td>
<td></td>
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<tr>
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<td>Business</td>
<td>$10,000</td>
<td>100%</td>
<td>$105</td>
<td>35%</td>
<td></td>
<td>$84</td>
<td>28%</td>
<td></td>
</tr>
<tr>
<td>Montana</td>
<td>Both</td>
<td>$300</td>
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<td>$400</td>
<td>15%</td>
<td></td>
<td>$213</td>
<td>8%</td>
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<tr>
<td>Oklahoma</td>
<td>Individual</td>
<td>$2,667</td>
<td>75%</td>
<td>$20,000</td>
<td>15%</td>
<td></td>
<td>$10,667</td>
<td>8%</td>
<td></td>
</tr>
<tr>
<td>Oklahoma</td>
<td>Business</td>
<td>$133,333</td>
<td>75%</td>
<td>$256,278</td>
<td>12%</td>
<td></td>
<td>$100,800</td>
<td>5%</td>
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</tr>
<tr>
<td>Pennsylvania</td>
<td>Business</td>
<td>$133,333</td>
<td>75%</td>
<td>$472,944</td>
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<td></td>
<td>$340,800</td>
<td>18%</td>
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<td>$111,111</td>
<td>90%</td>
<td>$13,333</td>
<td>10%</td>
<td></td>
<td>$4,000</td>
<td>3%</td>
<td></td>
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<tr>
<td>Rhode Island</td>
<td>Business</td>
<td>$111,111</td>
<td>90%</td>
<td>$27,778</td>
<td>25%</td>
<td></td>
<td>$20,000</td>
<td>18%</td>
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<td>South Carolina</td>
<td>Both</td>
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<td>100%</td>
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<td>6%</td>
<td></td>
<td>No profit</td>
<td>No profit</td>
<td></td>
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<tr>
<td>Virginia</td>
<td>Individual</td>
<td>$125,000</td>
<td>65%</td>
<td>$550</td>
<td>6%</td>
<td></td>
<td>No profit</td>
<td>No profit</td>
<td></td>
</tr>
<tr>
<td>Virginia</td>
<td>Business</td>
<td>Unlimited</td>
<td>65%</td>
<td>$2,200</td>
<td>6%</td>
<td></td>
<td>No profit</td>
<td>No profit</td>
<td></td>
</tr>
</tbody>
</table>

a "Business" refers only to businesses subject to the individual income tax.

Arizona and Virginia do not impose caps on business taxpayers' maximum eligible donation, and South Carolina does not impose caps on any taxpayer. But total annual tax credit distributions in these states are limited to $67 million in Arizona for the business portion of the credit, $10 million in South Carolina, and $25 million in Virginia.

In practice, potential benefits under the 35 percent marginal AMT rate are limited by the fact that only taxpayers with Alternative Minimum Taxable Income below $494,900 (in 2016) face this rate.

Oklahoma's 75 percent credit is only available to taxpayers who pledge to contribute for two consecutive years. The state's 50 percent credit for single year contributions cannot be used to generate a profit.

Assuming contributions of $1,000,000 each under both the OSTC and EITC, plus $221,111 under the Pre-K portion of the EITC.

Assuming contributions of $833,333 each under both the OSTC and EITC, plus $221,111 under the Pre-K portion of the EITC.

Most of Pennsylvania's credits are limited to 75 percent for single year contributions and 90 percent for taxpayers who pledge to contribute for two consecutive years. The first $10,000 in contributions for Pre-K scholarships receive a 100 percent credit and the next $211,111 of contributions receive a 90 percent credit.

Rhode Island's 90 percent credit is only available to taxpayers who pledge to contribute for two consecutive years.

Because South Carolina and Virginia allow taxpayers to claim scholarship tax credits based on the market value of marketable securities, even larger profit margins are available to taxpayers that avoid federal and state capital gains taxes by donating appreciated stock. The potential profit margin depends on the degree to which the stock has appreciated.

Source: Institute on Taxation and Economic Policy (ITEP)
The amount of benefit that can be realized by this reclassification depends on the amount of AMT owed and the taxpayer’s marginal tax rate under the AMT. Since marginal tax rates under the AMT range as high as 35 percent (after taking into account the AMT exemption phase-out), every dollar donated can potentially result in a federal tax cut of up to 35 cents. When combined with a dollar-for-dollar state tax credit, this means that a private school “donation” in South Carolina is better than costless, and can actually result in a risk-free return as high as 35 percent of every dollar “donated.”

As shown in Figure 2, South Carolina’s 35 percent maximum return on scholarship contributions is one the most lucrative in the nation. Of the nine states where taxpayers can turn a profit by claiming federal and state tax benefits on the same contribution, only Montana matches South Carolina in offering potential profit margins of this size. However, Montana places a limit on the maximum donation that can be subsidized via a credit—the state’s $300 cap means that no taxpayer will receive more than $105 in profit in a given year. The next highest profit margin (33 percent) is available in Alabama, where a much higher cap on eligible donations ($50,000) allows for profits as large as $16,625 per year. But South Carolina’s limits on tax credit claims are significantly looser than in either of these two states. The maximum size of any taxpayer’s credit in South Carolina is not subject to a firm cap, though taxpayers cannot receive credits in excess of 60 percent of their tax liability and the state will not distribute more than $10 million in total credits in a given year.

In the other six states where these tax credits can be paired with deductions to turn a profit, various tax rules (e.g., lower credit percentages, interactions with state itemized deduction rules, or the offsetting effects of state deductions for federal taxes paid) reduce the percentage yields to 30 percent or less. Nonetheless, scholarship contributors with sufficient resources and enough knowledge of the federal AMT can still earn tens of thousands of dollars, or more, risk free in a single year. While a tax savvy business owner in Pennsylvania, for example, faces a lower profit margin (up to 25 percent) than in Alabama (up to 33 percent), Pennsylvania’s much higher cap on eligible donations allows for much larger potential profits. Under the right set of circumstances, a Pennsylvania business owner could reap hundreds of thousands of dollars in profit in a single year. Other states with particularly lucrative scholarship tax benefits include Arizona and Virginia, where business owners are eligible to receive tax credits without limit.

Many scholarship organizations have realized that the profit-generating opportunities outlined above may appeal to donors that would otherwise be interested in giving to private schools. One organization based in Georgia, for example, brags to potential donors that “you will end with more money than when you started.” Similarly, a tax lawyer in Alabama notes on her firm’s website that for taxpayers subject to the AMT, “donating” will actually “put money in your pocket.” Private schools in Oklahoma and Pennsylvania have attempted to demonstrate the potential monetary gains of “donating” with hypothetical examples showing the financial returns of participating in their states’ programs. And while they may not hold

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9 The cap is $150 for individuals and $300 for married couples filing jointly.  
10 Scholarship credits in another seven states cannot be used to turn a profit because the credit percentage is too small (Indiana), the credit cannot be paired with a state charitable deduction (Iowa), or because the credit is not available to taxpayers subject to the personal income tax and thus the federal individual AMT does not apply (Florida, Kansas, Nevada, New Hampshire, and South Dakota). 
11 Arizona and Virginia do cap the overall amount of tax credits available statewide each year, however.  
Other Types of Tax Benefit Stacking

For taxpayers subject to the federal Alternative Minimum Tax (AMT), federal charitable deductions are typically the most lucrative tax benefit that can be stacked on top of state scholarship tax credits. But there are at least two other types of tax preferences that can be claimed alongside these credits in certain states.

First, while most states prohibit taxpayers from claiming a state-level charitable deduction for donations that were also eligible for a state tax credit, three states (Louisiana, Oklahoma, and Virginia) actually allow this type of double dipping. Since Oklahoma and Virginia do not allow taxpayers to deduct their state income tax payments from their state tax bills, converting non-deductible state tax payments into deductible charitable “donations” is a lucrative benefit. In Louisiana, where both state income tax payments and charitable donations are deductible, the benefit is smaller since only the portion of the donation that is not directly offset by a state tax credit triggers a tax benefit.

Second, South Carolina and Virginia allow taxpayers to receive scholarship credits not just on cash donations, but also on the market value of any stock that they donate. This feature opens the door to additional profit opportunities for investors in these states. When a taxpayer donates stock that has appreciated in value, they receive not just the state tax credit and state and federal charitable deductions already described, but also the ability to avoid paying any state or federal tax on the capital gains income generated by that stock. When donating stock that has grown significantly in value since it was purchased, the tax benefit of this “donation” can far exceed the actual value of the stock donated.

An ITEP review of those states where credits are available under the personal income tax found that donations subsidized via a state tax credit cannot also be taken as a state deduction for charitable contributions in Alabama, Arizona, Georgia, Iowa, Montana, and South Carolina. Indiana, Pennsylvania, and Rhode Island do not allow charitable deductions of any kind.

The potential profit opportunities depend on the degree to which the stock has appreciated in value. For example, one hypothetical scenario circulated by a Catholic school and associated foundation in Roanoke, Virginia depicts a taxpayer enjoying a risk-free return of 19.4 percent on their “donation.” Roanoke Catholic School and McMahon Parater Foundation for Education. “Frequently Asked Questions: Education Improvement Scholarships Tax Credits.” March 2014. Available at: https://s3.amazonaws.com/roanokecatholicschool/roanokecatholicschool/wp-content/uploads/2014/03/EIS-Donor-FAQ-3-14-Roanoke.pdf.

Wealthy taxpayers appear to have taken notice. In Georgia, the state’s entire allotment of $58 million in scholarship credits was claimed in a single day on January 1, 2016. Later in the year, the same occurred within a matter of hours with regard to $67 million of credits in Arizona and $763,550 in credits in Rhode Island. While taxpayer confidentiality laws generally conceal the magnitude of the benefits received by specific claimants, a journalist in South Carolina estimated that one savvy,


anonymous taxpayer was able to reap a profit of between $100,000 and $638,000 in 2014 by stacking state, and possibly federal, deductions on top of scholarship tax credits.\textsuperscript{18}

**OTHER ISSUES WITH PRIVATE SCHOOL TAX SUBSIDIES**

Tax subsidies, or neovouchers, for private education are problematic both as tax policies and as education policy initiatives. Aside from the profit-making schemes just described, other issues associated with these programs include:

- *Dubious educational benefits for recipients.* Neovouchers are often touted as a way to improve educational outcomes by making it possible for families in areas with underperforming public schools to send their children to private schools instead. But there is little evidence that voucher programs of any kind have improved educational outcomes, and some recent studies suggest that students switching from public to private schools in Indiana and Louisiana actually scored lower on reading and math tests after making the switch.\textsuperscript{19} Moreover, it can be difficult for parents to determine the actual quality of private schools in their area when those schools are not subject to the same accountability mechanisms as public schools. In Pennsylvania, for instance, schools benefiting from the state’s neovoucher program are exempt from state testing requirements and from reporting information on student progress or achievement.\textsuperscript{20}

- *Erosion of the public education system.* While neovouchers are unlikely to improve educational outcomes for students moving to private schools, the negative impact on those students remaining in public schools is even clearer. Thirty neovouchers across twenty states are draining over $1 billion in public revenues from state coffers every year. Every dollar of revenue diverted toward private schools is revenue that cannot be invested in the public education system. Allowing certain taxpayers to opt out of funding an institution as fundamentally important as the nation’s public school system erodes the public’s level of investment in that institution—both literally and figuratively.

- *Exaggerated cost savings.* Neovoucher proponents often claim that state and local governments can realize substantial savings by moving students out of the public school system and into private schools. But while reductions in public school enrollment may reduce certain costs in certain circumstances, many costs are relatively fixed (maintenance, utilities, administration, etc.) and cannot be easily cut when students leave.\textsuperscript{21} Moreover, when neovouchers are provided to families whose children would have been enrolled in private school anyway, the result is a loss of revenue without any actual reduction in enrollment or school district expenses. Research on Arizona’s tax credit program, for instance, found that most spending is directed toward students already enrolled in private schools.\textsuperscript{22} And dramatic increases in funding


\textsuperscript{19} For discussions of some of this literature, see: "Analysis of Indiana School Choice Scholarship Program." Center for Tax and Budget Accountability. April 2015. Available at: http://www.ctbaonline.org/file/4131/download;token=VPo6T1H. Dynarski, Mark. "On negative effects of vouchers." Evidence Speaks Reports, Vol 1, #18. Brookings Institution. Available at: https://www.brookings.edu/research/on-negative-effects-of-vouchers/.


\textsuperscript{22} Wilson, Glen Y., "The Equity Impact of Arizona’s Education Tax Credit Program: A Review of the First Three Years." Arizona State University Education Policy Research Unit (http://epu.asu.edu/cpnu/documents/FPRU%202002-110/cpnu-0203-110.htm)
for Arizona's neovoucher programs do not appear to be leading to an exodus of public school students—enrollment in private schools has stagnated while public school enrollment has increased significantly.\(^3\)

- **Poorly targeted.** Though frequently justified as a lifeline for disadvantaged children, the beneficiaries of neovoucher programs are often not low-income students. States such as Oklahoma and Pennsylvania allow upper-middle income families to benefit from scholarship subsidies, while other states such as Arizona, Georgia, and Montana allow even high-income families to benefit. Subsidies for tuition and other private school expenses are also typically made available regardless of income level. Making matters worse are the specific design decisions behind many of these tax subsidies. Tax deductions and nonrefundable credits are of no help to low-income families that earn too little to owe income tax. For that reason, even neovoucher advocates have suggested converting programs such as Wisconsin's tuition deduction into refundable credits (though it is important to note that such a conversion would likely result in a dramatic increase the program's overall cost).\(^4\)

- **Constitutional issues.** Advocates of state subsidies for private education, such as the American Legislative Exchange Council (ALEC), often encourage states to administer their voucher programs via the tax code in order to circumvent state constitutional prohibitions on the public funding of religious schools.\(^5\) According to ALEC, while lawmakers in eighteen states are constitutionally forbidden from offering direct vouchers for religious schools, tax credit neovouchers can be used to accomplish a nearly identical result in all but two of those states.\(^6\) In some cases, these schools have curricula (such as biblical versions of science and history) or personnel policies (such as firing teachers if they enter a same-sex marriage or become pregnant outside of wedlock) that would be prohibited at a public institution and that raise questions about the appropriateness of directing public dollars toward these schools.\(^7\) Arizona is perhaps the most well-known example of a state that succeeded in labeling its subsidies as "tax reductions" rather than "direct spending" in order to circumvent its own constitution. In 1998, the Arizona Supreme Court ruled 3-2 in *Kotterman v. Killian* that, unlike a traditional voucher, the state's tax credit scholarships were not in violation of the Arizona Constitution in part because the credits are technically diverted to private schools before reaching the state's coffers. In 2011, the U.S. Supreme Court reached a similar conclusion in a 5-4 ruling in *Arizona Christian School Tuition Organization v. Winn*. But while neovouchers have so far been upheld on relatively narrow grounds, Supreme Court Justice Elena Kagan cut to the heart of the matter when she explained in her dissent that "cash grants and targeted tax breaks are means of accomplishing the same government objective—to provide financial support to select individuals or organizations."

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\(^6\) Ibid. The sixteen states allowing neovouchers but not ordinary vouchers include Alaska, California, Delaware, Florida, Hawaii, Idaho, Kentucky, Missouri, New Hampshire, New Mexico, Oregon, South Dakota, Vermont, Virginia, Washington, and Wyoming. In Massachusetts and Michigan, both vouchers and neovouchers are unconstitutional. According to ALEC, Educational Savings Accounts are constitutional in Arizona though traditional vouchers are not.

- **Lack of budgetary oversight.** Subsidies for private education provided via neovouchers are often not subject to the same budgetary oversight as ordinary spending on public education. Most notably, once a neovoucher is enacted into law it typically continues indefinitely without reexamination as part of the appropriations process. Moreover, those neovouchers not subject to an aggregate budgetary cap can grow significantly in cost without any action on the part of lawmakers. And even those neovouchers that are subject to caps sometimes see the cap structured in a way that allows for growth that far outpaces other areas of the budget, such as one of Arizona’s neovouchers for corporate taxpayers which is currently growing at a rate of 20 percent per year.

**CONCLUSION**

Rather than enhancing educational opportunities, tax subsidies for private education often benefit students already enrolled in private schools while reducing the amount of state revenue available for public schools. Worse still, they undermine support for public education and give credence to the false notion that citizens who send their children to private schools have no obligation to support public schools.

On top of these problems, upper-income families that are able to exploit complex interactions between state and federal tax law can sometimes use these backdoor subsidies to generate a profit for themselves. This is made possible largely because the IRS currently allows taxpayers to claim a charitable deduction for private school contributions even when those contributions were fully reimbursed by the state and were therefore not truly charitable in nature. The resulting profits being collected by a small group of savvy taxpayers represent a drain on public revenue that ultimately benefits neither private nor public school students.

Neovouchers are an inefficient and opaque way of redirecting public dollars toward private schools. Nonetheless, these tax subsidies are being enacted in a growing number of states. It appears that their growing prevalence is partly attributable to their usefulness in sidestepping state constitutional restrictions, and partly because their lack of transparency helps avoid opposition from a public that generally opposes spending public funds on private schools.

Note: This report was updated in May 2017 to acknowledge that South Carolina taxpayers can profit by donating stock that has appreciated in value, and that Louisiana’s tuition donation rebate does not allow taxpayers to turn a profit because the rebate is considered to be taxable income in the year in which it is received.

APPENDIX: DETAILS ON STATE TAX SUBSIDIES FOR PRIVATE K-12 EDUCATION

<table>
<thead>
<tr>
<th>State</th>
<th>Category Description</th>
<th>Tax Year</th>
<th>Cost</th>
</tr>
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<tbody>
<tr>
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<td>Private School Scholarship and/or Expenses</td>
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<td>Private School Scholarship and/or Expenses</td>
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<td>$251,576</td>
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<td>Illinois</td>
<td>Private School Scholarship and/or Expenses</td>
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<td>$78.4 million</td>
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<td>Indiana</td>
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EXHIBIT C
Capturing Federal Dollars With State Charitable Tax Credits

by Phillip Blackman and Kirk J. Stark

In ongoing debates about how to fund state and local public goods, one strategy stands out for its ability to engender bipartisan agreement: more money from the federal government. The Golden State is no exception. Despite pervasive disagreement over the size of government and the level of taxes required to pay for it, Californians are generally united in the view that the state is getting a raw deal vis-à-vis the federal government. Polling data consistently show that roughly two-thirds of Californians think the state should receive more federal assistance, including a majority of Democrats, Republicans, and independents.1 Playing on those sentiments during his gubernatorial campaign in 2003, Arnold Schwarzenegger said, "By the time I'm through with this whole thing, I will not be known as the Terminator — I will be known as the Collectinator."2 Jerry Brown sounded a similar theme seven years later, vowing to "stop leaving federal money on the table."3 Whatever the merits of those bipartisan proclamations as a political matter, there is little indication that Washington is prepared to rework the distribution of federal spending or taxes in California's favor.

Importantly, however, not all policies directing additional federal support to the state require congressional approval. This report considers a legislative strategy for increasing federal funds that California, or any other state, could enact on its own initiative: the adoption of a state income tax credit for charitable contributions that augment or defray selected state or local government expenditures. If respected by federal tax authorities, such a credit would enable taxpayers to convert state income tax payments to charitable contributions on their federal income tax returns. That would reduce the federal income tax liability of taxpayers subject to the federal alternative minimum tax, which disallows deductions for state and local taxes but permits them for charitable contributions. Also, if the state were to adopt a transferable charitable tax credit, taxpayers could convert ordinary income to capital gains, reducing their federal

1Public Policy Institute of California, "Californians and Their Government" (Jan. 2010).

"Bucks loves strategies that allow you to beat the system, especially when you can do some good in the process."

— Bucks blog,
income tax liability by as much as 20 cents on the dollar based on current tax rates. In both cases, the state government would share in the federal tax savings to the extent the charitable tax credit does not fully compensate taxpayers for their donations.

While that outcome may sound too good to be true, recent legal guidance from the IRS Office of Chief Counsel appears to support that strategy. Asked to opine on the effects of a state income tax credit for charitable donations, the chief counsel in 2010 concluded that the taxpayer was allowed to deduct the full amount of her charitable contribution to a state agency even though she received a state income tax credit for some (unspecified) percentage of that amount.\(^4\) A recent Tax Court decision appears to support the IRS position, accepting a couple’s charitable contribution deduction for charitable contributions, which are generally ignored in calculating the amount of a donor’s federal deduction, but it is at variance with other legal authority requiring a taxpayer to reduce the amount of her charitable contribution deduction by the amount of cash and the value of any property or services received in exchange for the gift.

Our analysis considers the federal income tax consequences of state charitable tax credits and critically evaluates the chief counsel memorandum on the topic. We consider the significance of the chief counsel’s analysis for SB 284, draft legislation recently proposed by California state Sen. Kevin de León (D) that would permit an income tax credit for some contributions to a college access tax credit fund (CATCF). The CATCF program offers a framework for considering how California might take advantage of the chief counsel’s 2010 memorandum. Our analysis casts doubt on the chief counsel’s conclusions and thus also calls into question the federal tax benefits supposedly associated with SB 284. Nevertheless, given the IRS’s position, the CATCF program deserves consideration as a way for California to pursue fiscal “self-help” using creative tax planning. While we believe the CATCF strategy should not produce the federal tax benefits it purports to produce, IRS guidance appears to provide a legal opening for those hoping to act on the state’s Collectinator impulses.

II. Mechanics of Federal Tax Law

Understanding the possible benefits to California of adopting an income tax credit for charitable contributions requires a brief overview of relevant federal tax rules, including the deduction for charitable contributions, the deduction for state and local taxes, and the differential treatment of charitable contributions and state and local taxes for purposes of the federal AMT.

A. Charitable Contributions

Section 170 allows a deduction for “any charitable contribution . . . payment of which is made within the taxable year.”\(^6\) Significantly, the statute goes on to define a charitable contribution as a “contribution or gift to or for the use of . . . a state, possession of the United States, or any political subdivision of any of the foregoing . . . but only if the contribution or gift is made for exclusively public purposes.”\(^7\) While charitable gifts to state governments are less common than donations to other types of charitable organizations, the statute is clear that the term “charitable contribution” encompasses those gifts.\(^8\)

Like all charitable donations, gifts to state and local governments are subject to the general rules and limitations applicable to charitable contributions, including those set forth in Treasury regulations or developed through judicial doctrines over the years. Of particular relevance to our analysis is the limitation in reg. section 1.170A-1(h)(1), providing that “no part of a payment that a taxpayer makes to or for the use of an organization described in section 170(c) that is in consideration for . . . goods or services (as defined in section 1.170A-13(f)(5)) is a contribution or gift within the meaning of section 170(c) unless the taxpayer — (i) Intends to make a payment in an amount that exceeds the fair market value of the goods or services; and (ii) Makes a payment in an amount that exceeds the fair market value of the goods or services.”\(^9\) The term “goods or services” is defined to include cash, property, services, benefits, and privileges.\(^10\)

That rule accords with the common-sense notion that a charitable gift entails parting with something of value. To the extent that the taxpayer is receiving an item of value in exchange for her contribution, it would seem appropriate to reduce the amount of the taxpayer’s charitable contribution deduction by the FMV of whatever is received. Accordingly, the regulations specify that any otherwise allowable charitable contribution deduction cannot exceed the excess of (1) the amount of any cash and the FMV of any property (other than cash) transferred by the taxpayer to an organization described in section 170(c), over (2) the FMV of the goods or services the organization provides in return.\(^11\)

That approach should be familiar to anyone who has made a donation to organizations such as NPR or PBS during one of their pledge weeks. It is not uncommon for those types of organizations to provide donors with an item of value in exchange for their gift. For example, in

\(^4\)IRM 201105010.
\(^6\)Section 170(a).
\(^7\)Section 170(c).
\(^8\)Of course, gifts to state colleges and universities (as well as public schools at the K-12 level) are not uncommon, although those contributions would be deductible as charitable gifts even if the schools were private because the statute permits deductible contributions to educational organizations. For a thorough review of the different types of governmental entities and affiliates for purposes of various federal income tax rules, including the charitable contribution deduction, see Ellen April, “The Integral, the Essential, and the Instrumental,” 23 J. Corp. Law 803 (1998).
\(^9\)Reg. section 1.170A-1(h)(1).
\(^10\)Reg. section 1.170A-1(h)(5).
\(^11\)Reg. section 1.170A-1(h)(1).
exchange for a gift of $500, PBS might send a donor a complete DVD set of the Ken Burns documentary on the Civil War. If that DVD set has an FMV of $100, the taxpayer’s charitable contribution will be limited to $400 — that is, the excess of the amount contributed ($500) over the FMV of the goods received in exchange ($100).

Surprisingly little attention has been given to the interaction between the rules just summarized and the availability of state income tax benefits arising from charitable gifts. As is common for states with an income tax to follow the federal tax code in providing a deduction for charitable contributions. Thus, in the above example, the taxpayer may be able to claim a $400 charitable contribution deduction not only on her federal Form 1040, but also on her state income tax return. Assuming a federal tax rate of 35 percent and a state tax rate of 10 percent, a $400 deduction will reduce the taxpayer’s federal income tax liability by $140 and reduce her state income tax liability by $40.

In most cases, the state tax benefits arising from a charitable donation are not likely to be significant, in part because state income tax rates are much lower than federal income tax rates. Also, the reduction of the taxpayer’s state income tax liability has its own federal income tax consequences — that is, reducing the amount of otherwise deductible state income tax payments. However, matters are complicated — and the stakes potentially increased — when a state offers an income tax credit for charitable gifts rather than a deduction. Unlike a deduction, a credit is a dollar-for-dollar reduction in a taxpayer’s state income tax liability. Whereas the dollar value of a deduction is a function of the taxpayer’s marginal tax rate, the dollar value of a credit is a function of the credit percentage available under the credit.

For example, assume that a state adopts a 40 percent income tax credit for donations to PBS and taxpayer Dora makes a $1,000 donation to her local PBS station. Assume further that Dora’s marginal tax rate under her state’s income tax is 10 percent. If Dora were to claim a state charitable contribution deduction for her $1,000 donation, it would save her $100 in state income taxes. By contrast, an income tax credit with a 40 percent credit percentage would reduce Dora’s state income tax liability by $400. Deductions and credits are merely two different ways of accomplishing the same result; however, credits give policymakers more flexibility because the subsidy rate can be set independently of marginal tax rates.

Some states have recently adopted state income tax credits with extraordinarily high credit percentages, including some with a 100 percent state income tax credit. It is worth pausing for a moment to reflect on what it means for a state to offer a 100 percent income tax credit for a charitable gift. Can such a transfer even be considered a “gift”? Returning to our Dora/PBS example, assume that Dora’s state permits a 100 percent income tax credit for donations to PBS up to an amount of $1,000. Under the terms of the statute, a $1,000 “gift” to PBS would let Dora reduce her state income tax liability by $1,000. In effect, Dora is directing the state to transfer $1,000 of what would otherwise be state income tax revenue to PBS. Such a scheme raises some interesting questions about politics and democratic theory. For example, who should decide how that $1,000 is spent, a state’s elected representatives, or the taxpayers who make those donations? But those questions are beyond the scope of this analysis.

A 100 percent state income tax credit has the dual effect of increasing the taxpayer’s charitable contributions by the amount donated and reducing the taxpayer’s state income tax payments by the same amount. In effect, the availability of a 100 percent state income tax credit for charitable gifts permits the taxpayer to “convert” what would otherwise be state tax payments to charitable donations. When the donee is not a private organization, but rather the state government itself, the only real change is one of labeling. In other words, if Dora makes a $1,000 gift to her state and is thereby allowed to claim a $1,000 state income tax credit, all she really has done is convert what would otherwise have been a $1,000 state income tax liability into a $1,000 charitable gift.

B. Deduction for State and Local Taxes


For example, the National Conference of State Legislatures reports that several states have adopted income tax credits for donations to qualifying school tuition organizations (STOs). Those include programs with credit percentages ranging from 50 to 100 percent (see NCSL, “Tuition Tax Credits: Overview”). The availability of those tax credits for donations to tuition organizations in Arizona was the subject of Arizona Christian School Tuition Organization v. Winn, 131 S. Ct. 1436 (2011).

In Arizona Christian, 131 S. Ct. 1436, Justice Anthony Kennedy said, “When Arizona taxpayers choose to contribute to STOs, they spend their own money, not money the State has collected from respondents or from other taxpayers” (emphasis added). That conclusion is relevant to whether the parties challenging the constitutionality of the Arizona statute or establishment clause grounds had standing to pursue the lawsuit. For an opposing perspective noting the fundamental interchangability between government expenditures and tax credits, see Justice Elena Kagan’s dissenting opinion in the case.
some circumstances, retail sales taxes.\textsuperscript{17} That longstanding provision of federal tax law should negate any benefit associated with converting state income tax payments to a charitable gift. In the example described above, if Dora claims a 100 percent state income tax credit for her $1,000 donation to PBS, all she has done is reduce her (federally deductible) state income taxes and increase her (federally deductible) charitable contributions. Because both state income tax payments (section 164) and charitable contributions (section 170) are deductible for purposes of the federal income tax, converting a $1,000 transfer from one category to the other should have no meaningful federal income tax consequences.

Significantly, however, state income tax payments and charitable contributions are treated differently for purposes of the federal AMT. Whereas charitable contributions are deductible for both the regular income tax and the AMT, state and local taxes are deductible only for the regular income tax. More precisely, section 56(b)(1)(A)(ii) provides that "in determining the amount of the alternative minimum taxable income...no deduction shall be allowed...for any taxes described in paragraph (1), (2) or (3) of section 164(a)." As a result of that provision, taxpayers subject to the AMT typically receive no federal income tax benefit from the deduction for state and local taxes. Thus, while a taxpayer subject only to the regular income tax should generally be indifferent to the classification of a payment as a charitable contribution or a state tax payment, an AMT payer generally will prefer to have a payment classified as a charitable contribution rather than a state tax payment because the former is deductible while the latter is not.\textsuperscript{18}

Until recently, the AMT was a relatively insignificant feature of the U.S. fiscal structure. It was enacted as part of the Tax Reform Act of 1969 in response to revelations that 155 taxpayers with incomes exceeding $200,000 had zero federal income tax liability for 1966.\textsuperscript{19} Congress responded with the AMT to ensure that wealthy taxpayers pay at least some minimum amount of income tax. Over time, various changes to the AMT structure, along with the fact that its key parameters (for example, the AMT exemption or the breakpoint between the AMT rates) were not indexed for inflation, converted the AMT from a relatively minor add-on tax to a fairly significant feature of the U.S. federal income tax. In very general terms, the AMT can be described as having a broader base (because it features fewer deductions) and lower rates (with a top rate of 28 percent, compared with 39.6 percent) than the regular income tax.

By far the most significant AMT preference item is the deduction for state and local taxes, accounting for more than two-thirds of total AMT preferences and adjustments in recent years.\textsuperscript{20} As a result, AMT participation rates are highest in those states where state and local tax burdens are the greatest. The Urban-Brookings Tax Policy Center estimated that in 2007 "families in high-tax states were almost three times more likely to face the AMT than those in low-tax states." States with the highest number of total returns featuring AMT liability are California, Connecticut, Maryland, Massachusetts, New Jersey, and New York.

C. California AMT Data

IRS data reveal more detail about the operation of the AMT in California. For tax year 2010, approximately 4.5 percent of federal income tax returns filed in California showed some AMT liability. Nearly all those returns (96 percent) were filed by taxpayers with adjusted gross incomes exceeding $100,000, and three-quarters were filed by taxpayers with AGIs exceeding $200,000.\textsuperscript{21} Thus, as is true throughout the country, AMT liability of Californians is concentrated in the top decile of the income distribution.\textsuperscript{22} For those taxpayers, an increase in their state tax liability will have no effect on their federal income tax liability because of the nondeductibility of state and local taxes under the AMT. However, an increase in charitable contributions would reduce their federal income tax liability by the amount of the contribution multiplied by the marginal tax rate, which for those subject to the AMT would be either 26 or 28 percent.\textsuperscript{23}

III. Effects of a State Charitable Tax Credit

The differential treatment of state and local taxes and charitable contributions under the AMT creates an opportunity for tax planning. The tax planning we have in mind is not the conventional variety, in which an individual or business entity engages the expertise of a tax lawyer or accountant with an eye toward minimizing its tax obligations. Rather, what we envision is state legislation enacted specifically for the purpose of exploiting the federal tax code's differential treatment of those two types of payments.

We offer our analysis merely as a thought experiment in the hopes of revealing the intuition underlying the idea. Our aim is not to endorse a California state charitable tax credit — indeed, we have some doubts about its viability as a means of capturing additional federal resources for the state. Rather, we will highlight the

\textsuperscript{17} Section 164.

\textsuperscript{18} Even outside the AMT context, taxpayers should generally prefer deductible charitable contributions to nondeductible state and local taxes, such as retail sales taxes or gas taxes, suggesting that a tax credit scheme aimed at converting state sales or gas tax liability to charitable contributions would be subject to the same type of analysis described in the text. Tax credits are far less common in those contexts than in the income tax context.


\textsuperscript{20} Tax Policy Center, "Reconciling AMTI and Taxable Income for AMT Taxpayers" (Dec. 21, 2010) (deduction for state/local taxes accounted for more than 68 percent of AMT adjustments and preferences for 2008).

\textsuperscript{21} IRS Statistics of Income, "Historic Table 2" (2010).

\textsuperscript{22} See Emmanuel Saez, "Striking It Richer: The Evolution of Top Incomes in the United States" (updated with 2009 and 2010 estimates), Figure 2 (Mar. 2, 2012) (noting that the breakpoint for the top decile, based on national figures, was $108,000 in 2010).

\textsuperscript{23} Section 55(b)(1)(A)(ii).
technical legal questions that would need to be answered to ensure that such a credit would have the desired effects.

A. (Potential) Federal Tax Benefits

The potential benefit of a state income tax credit for charitable contributions is best understood with an extreme example — that is, a 100 percent California state income tax credit for donations to a California state charitable contribution fund (CSCCF) — which we will refer to as Example A. Assume the purpose of the fund will be to undertake some sort of activity that has the effect of defraying state general fund expenditures. Taxpayer Joe, who has federal AGI between $400,000 and $500,000 and is subject to the federal AMT, plans to contribute $10,000 to the fund.

If respected as a charitable gift, the contribution will entitle Joe to a $10,000 income tax credit on his California state income tax return and a $10,000 charitable contribution deduction on his federal income tax return. The $10,000 California state income tax credit fully compensates Joe for the contribution. Thus, while his state income tax liability has decreased by $10,000, his total payment to the state has not changed; it's just that $10,000 is directed to the CSCCF instead of to the state's general fund. From the state's perspective, that should be simply an accounting maneuver, at least insofar as CSCCF resources are used to defray general fund expenditures.

By contrast, the effect on Joe's federal income tax liability is more meaningful. While the $10,000 reduction in Joe's state income tax payments has no effect (because he is subject to the AMT and thus enjoys no benefit from state and local tax deductions), his charitable contribution deduction has increased by $10,000. At a marginal tax rate of 28 percent, Joe should see a reduction in his federal income tax liability of $2,800. Thus, merely by relabeling the $10,000 (from "tax" to "gift"), Joe saves $2,800 in federal taxes.

California may wish to adopt such a scheme solely for the benefit of taxpayers like Joe, or it may decide to offer a state income tax credit for some amount less than 100 percent in an effort to capture some portion of that $2,800 for public expenditures or other purposes. For example, let's modify our hypothetical slightly (Example B) and assume that the state income tax credit is 80 percent instead of 100 percent. Under that scenario, Joe's contribution of $10,000 would reduce his state income tax liability by only $8,000, with the result that his net payments to the state have increased by $2,000 as a result of his gift to the fund. However, the federal tax treatment of the transfer would remain the same — that is, his federal income tax liability would be reduced by $2,800 by virtue of the increase in his deductible charitable contributions by $10,000. In effect, when the state income tax credit is less than 100 percent, the state is able to claim a share of the federal tax savings arising from the transfer.

At this point, the reader is likely thinking (or, if not, perhaps should be), "This can't work." After all, the state income tax credit scheme described has all the markings of a transparent tax avoidance scheme — that is, mere paper shuffling and relabeling devised to reduce federal tax liabilities. That a state government is initiating the scheme does not make it any less objectionable on the grounds of substance over form or other judicial anti-avoidance doctrines. The right answer seems to be that the taxpayer's charitable contribution deduction should be reduced by the value of the state tax benefit arising from the transfer. Thus, in Example A, Joe's charitable contribution deduction for the $10,000 transfer to the CSCCF should be zero. In Example B, the allowable charitable contribution deduction should be $2,000. In both cases, to allow a charitable contribution deduction of $10,000 on the federal return is to ignore the significant state tax benefit arising from the income tax credit. That result seems to follow from the Treasury regulations discussed.

Despite seeing those answers as "correct," we see two problems. First, the IRS has recently taken a contrary view, concluding that a state or local tax benefit, for example, a state income tax credit for donations of cash or property to a state agency, "is treated for federal tax purposes as a reduction or potential reduction in tax liability" and not as consideration that might constitute a quid pro quo for purposes of section 170. Second, for the IRS to rule otherwise likely would require a broader reconsideration of the long-standing principle that "the tax benefit of a federal or state charitable contribution deduction is not regarded as a return benefit that negates charitable intent, reducing or eliminating the deduction itself." Those passages are from the chief counsel's office 2010 memorandum on this issue.

B. ILM 201105010

In early 2011 the IRS Office of Chief Counsel released a memorandum it had prepared in October 2010 regarding the deductibility of donations that entitle the taxpayer to a state-level tax credit. Although the memorandum considered whether a taxpayer's contribution of cash or other property to a state agency should be considered a charitable deduction under section 170 or payment of a state tax under section 164 when the taxpayer receives a state income tax credit in lieu of a state charitable contribution deduction for the payment.

While the memorandum can be viewed as the office's current position on the topic, it bears noting that the advice in the memorandum "may not be used or cited as precedent." ILM 201105010, supra note 4, at 1.
The facts considered in the chief counsel's office analysis can be summarized as follows. Over the course of two years, the taxpayers contributed cash and appreciated property to some qualifying organizations under the terms of four tax credit programs adopted by State X. Under the law of State X, the tax credits could be used to reduce the taxpayers' state income tax liability in the year of the contribution, carried forward to the following year if unused in the year of the contribution, or sold to other taxpayers who would use the credits to reduce their state income tax liability.

In year 1, the taxpayers submitted applications to the State Department of Economic Development and was granted a state tax credit equal to an unspecified percentage of the contributions. The taxpayers used a portion of those credits to reduce their year 1 state tax liability, sold another portion to other taxpayers, and carried forward the remaining credits to future tax years. In year 2, the taxpayers submitted applications to the state for additional contributions and claimed the resulting state tax credits, as well as the credits carried forward from year 1, to offset their year 2 state income tax liability.

The chief counsel's analysis of the federal income tax consequences of those contributions is relatively brief and straightforward. To be deductible as a charitable contribution under section 170, a transfer to a charitable organization or government unit must be a gift, defined as "a transfer of money or property without receipt of adequate consideration, made with charitable intent," according to the IRS. Moreover, a transfer will not be considered to have been made with charitable intent "if the transferor expects a direct or indirect return benefit commensurate with the amount of the transfer." When the transferor receives some benefit in exchange for the contribution, "the transfer may be deductible as a charitable contribution, but only to the extent the amount transferred exceeds the fair market value of the benefit received, and only if the excess amount was transferred with the intent of making a gift."

An obvious question arising from those principles is whether the federal or state tax benefits accruing to a taxpayer as a result of making a charitable gift should be regarded as a "benefit received" that might reduce or eliminate the charitable nature of the transfer. In a series of cases cited in the chief counsel memorandum, federal courts generally held that the "tax benefit of a federal or state charitable contribution deduction is not regarded as a return benefit that negates charitable intent, reducing or eliminating the deduction itself."

In many of those cases, the court's conclusions are stated in very strong terms. For example, in McLennan, the U.S. Claims Court noted that "a donation of property for the exclusive purpose of receiving a tax deduction does not vitiate the charitable nature of the contribution." Likewise, in Skripak, the Tax Court stated that "a taxpayer's desire to avoid or eliminate taxes by contributing cash or property to charities cannot be used as a basis for disallowing the deduction for that charitable contribution." 28

The central question addressed in the chief counsel memorandum is whether a tax credit should be treated any differently from a tax deduction in assessing whether the taxpayer has received a benefit that might reduce or eliminate the federal income tax deduction. Because deductions and credits have essentially identical effects — that is, reducing the donor's income tax liability by some amount — it is hard to see why one would ignore the tax benefits associated with deductions while taking into account any tax savings arising from tax credits. It is possible that the value of a deduction (which depends on the taxpayer's marginal tax rate) and the value of a tax credit (which depends on the statutory credit percentage) may differ, but there is no reason to assume that either one will be systematically higher or lower than the other.

Perhaps in recognition of the fundamental interchangeability of credits and deductions, the IRS refused to apply a different rule for tax credits than the one that already applies for tax deductions, concluding that it saw no reason to "distinguish between the value of a state tax deduction, and the value of a state tax credit, or to draw a bright-line distinction based on the amount of the tax benefit in question." That language seems to suggest that the same treatment accorded to a tax deduction when the taxpayer's marginal state income tax rate is 10 percent would be extended when the taxpayer claims a state income tax credit, regardless of the statutory credit percentage. Significantly, however, the memorandum also states that "there may be unusual circumstances in which it would be appropriate to recharacterize a payment of cash or property that was, in form, a charitable contribution as, in substance, a satisfaction of tax liability."

In our view, the language just quoted likely represents an implicit recognition of the potential federal tax benefits to AMT payers from claiming especially "generous" state tax credits for charitable contributions. To be sure, those benefits arise from the use of less generous state tax credits, as well as tax deductions. Indeed, any payment that reduces an AMT payer's state income tax liability while increasing her charitable contribution deductions converts nondeductible taxes to deductible gifts to the extent of the reduction in state tax liability. In most cases, however, the magnitude of the federal tax benefit is relatively insignificant. For example, for deductions for state charitable contributions, the benefit is unlikely to exceed one-tenth of the amount of the gift because state income tax rates rarely exceed 10 percent. 29

When a state income tax credit features a higher credit percentage, the federal tax benefit is correspondingly

27McLennan, 23 Cl. Ct. 99.
28Skripak, 84 T.C. at 319.
29For example, in a state that follows federal law in allowing charitable contribution deductions, a $10,000 gift to charity would, assuming a 10 percent state income tax rate, reduce the donor's state income tax liability by $1,000 — in effect shifting $1,000 of nondeductible taxes to $1,000 of deductible donations.
greater. Again, the benefit to the taxpayer is greatest when the state allows a 100 percent income tax credit fully compensating the taxpayer for the cost of her “gift.” State tax credits featuring a lower percentage are naturally less attractive to the taxpayer but could generate resources for the state.

C. Transferable Tax Credits Under Tempel

Until now, we have been assuming a program in which the state income tax credit may be used only by the taxpayer making the initial contribution giving rise to the credit. It is possible, however, that the state will permit those credits to be sold by the original claimant and transferred to a taxpayer better positioned to make use of them. That was precisely the type of statute that the taxpayers took advantage of in Tempel v. Commissioner. The Tempel case illustrates a further benefit that might be derived from the adoption of a state charitable tax credit.

In December 2004 Colorado residents George and Georgette Tempel donated conservation easements to the Greenlands Reserve, a nonprofit organization formed to promote environmental protection and open space through the acquisition of negative easements limiting development on the donated property. To encourage the transfer of easements to those types of organizations, Colorado granted donors a state income tax credit equal to 100 percent of the first $100,000 of the value of the easement, plus 40 percent of the value of the easement exceeding $100,000. In no event could the credit exceed $260,000, and it could be used by the donors to reduce their Colorado state income tax liability. Consistent with ILM 201105010, taxpayers took advantage of the Tempel holding in the case. The IRS contended that the taxpayers realized ordinary income from the sale of the credits in 2004. It also determined that the taxpayers had a zero basis in the credits, with the result that they experienced a gain of $30,375 from the December 2004 sale.

At first blush, the holding seems to split the difference between the competing positions advanced by the taxpayers and the IRS. After all, short-term capital gain is generally taxed at the same rate as ordinary income, suggesting that while the Tax Court rejected the government’s position, the de facto result was equivalent to a government victory. Nevertheless, the Tempel holding is remarkable because it suggests that if the taxpayers had simply held the credits for more than one year they would have recognized long-term capital gain from their sale.

To illustrate, assume for the sake of analysis that the taxpayers in Tempel contributed a conservation easement worth $100,000 to Greenlands Reserve. Assume further that rather than use any of that credit to reduce their own state income tax liability, the Tempels instead sell the full $100,000 worth of credits for $100,000 after the requisite holding period. Taxes aside, they have experienced no increase or decrease in wealth, having parted with property worth $100,000 but receiving $100,000 cash. Note, however, that while the $100,000 “donation” will reduce the Tempels’ federal income tax liability by as much as $39,600 (that is, $100,000 multiplied by the top marginal tax rate of 39.6 percent), the $100,000 gain from the sale of the credits increases their federal income tax liability by only $20,000 (that is, $100,000 of long-term capital gain multiplied by the maximum rate on net capital gain of 20 percent). In effect, the donation permitted them to convert $100,000 of their ordinary income (via the charitable contribution deduction) to long-term capital gain.

By treating the sale of state charitable tax credits as the sale of a capital asset while also allowing a full deduction for gifts without reduction for the state tax benefits generated by the contribution, Tempel effectively empowers state governments to issue “capital gains coupons” in the form of transferable state charitable tax

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30Tempel, 136 T.C. 341.
credits. That outcome expands the population of taxpayers who could benefit from the adoption of a state charitable tax credit beyond just those taxpayers subject to the AMT. Any itemizing taxpayer subject to a marginal tax rate on ordinary income greater than the capital gains tax rate could benefit by making a gift that generates a transferable state charitable tax credit, claiming the full federal deduction for the gift, then later selling the credit at the lower capital gains rate.35

To illustrate the effects of that transaction, assume that taxpayer Dan makes a $100,000 donation to a California state agency and in exchange for that gift receives a $100,000 state charitable tax credit, which may be used to reduce his own state income tax liability or may be transferred to a third party for use in satisfying that person's state income tax liability. Under the logic of ILM 2011010050, Dan should be entitled to a federal charitable contribution deduction of $100,000, which should have the effect of reducing his federal income tax liability by as much as $39,600 (that is, $100,000 multiplied by the top marginal rate of 39.6 percent). If Dan is an itemizing taxpayer not subject to the federal AMT, using the credit to satisfy his own state income tax liability will have the dual effect of increasing his charitable contribution deduction by $100,000, and reducing his state and local tax deduction by $100,000. In other words, it's a wash for Dan.

However, if Dan sells his $100,000 hypothetical California state income tax credit to Boris, he will deduct $100,000 as a charitable contribution deduction under the logic of ILM 201105010 and recognize $100,000 of gain from the sale of the credits under Tempel. Assuming Dan holds the credits for a year before making the sale to Boris, the $100,000 gain should be taxed as long-term capital gain, most likely subject to the maximum statutory rate of 20 percent. Thus, the net benefit of the transaction is $19,600 to Dan (that is, $39,600 less $20,000). Meanwhile, Boris should be indifferent to paying $100,000 to Dan or to the state because, according to the IRS, "a purchaser of transferable Credits will be allowed a deduction under section 164 for State X income taxes paid with the purchased Credits."36

As with the nontransferable charitable tax credit described above, the state may decide to capture some portion of the tax savings by specifying a credit percentage less than 100 percent. For example, assume that the credit percentage is 90 percent and Dan again makes a donation of $100,000. With the lower credit percentage, Dan will be entitled to a tax credit of $90,000. If he later sells the credits to Boris for $90,000 (after the one-year holding period for long-term capital gains), he will deduct $100,000 as a charitable contribution deduction in year 1 (tax savings of $39,600 based on a 39.6 percent tax rate), and recognize $90,000 of long-term capital gain in year 2 (tax of $18,000 based on a 20 percent rate). Here, the net benefit from the federal government is $21,600 but it is divided between Dan ($11,600) and the state government ($10,000).37

There are numerous variations on those hypotheticals that could illustrate the effects in slightly different circumstances, involving taxpayers subject to higher or lower marginal tax rates, state credits for taxes other than income taxes, credits that could be used by businesses to offset their tax liability, and so on. While each of those situations presents slightly different tax implications, the core tax advantage in each case arises from the possibility that a taxpayer who transfers $X to a qualified entity, including a state agency, is entitled to deduct $X as a charitable contribution on her federal return even though she receives a state tax benefit — perhaps even a benefit equal to $X — as a result of making the gift.

IV. Tax Credit for Donations to Cal Grants

We have left unspecified the types of public programs that could benefit from a state charitable tax credit program. As noted in Section II, the only requirement of federal law concerning contributions to state agencies is that "the contribution or gift [be] made for exclusively public purposes." Thus, it would appear that states such as California have wide latitude in designing charitable tax credits.

For purposes of illustration, we will consider how such a program might work in the context of public higher education. De León recently introduced legislation to promote charitable contributions to fund an expansion of coverage under the Cal Grants program — the state's principal means of providing financial support for low- and middle-income students to pursue postsecondary education. The discussion that follows uses the de León legislation as a platform for considering how the state might take advantage of ILM 2011010050, the federal AMT's differential treatment of charitable contributions and state/local taxes, and the Tax Court's decision in Tempel.

A. The College Access Tax Credit

In February 2013 de León introduced S.B. 284, legislation that would have established a new college access tax credit program (CATCF) special fund, designed to provide new funding for Cal Grants.38 One rationale underlying S.B. 284 was the significant reduction in state

35 It is worth noting that while a payment by a purchaser of state tax credits "is clearly not a payment of tax or a payment in lieu of tax" that would be deductible under section 164, the IRS appears to accept as a deductible tax payment the use of the credit as a means of satisfying the credit purchaser's state tax liability, analogizing the use of the credit to a transfer of property by the taxpayer in satisfaction of her tax liability. See LTR 200346002.

36 Id.
support for higher education over the past quarter-century. A recent analysis suggests that per-student funding for public higher education in California declined by 46 percent between 1990 and 2012. In absolute dollar terms, California has reduced funding for public postsecondary institutions by $1.4 billion between 2006 and 2012. S.B. 284 appears to have been motivated by a desire to temper those effects by increasing funds available for middle-income households hoping to pursue postsecondary education.

The CATCF aimed to accomplish that using a state-level tax credit for taxpayers that make donations to the program. The language of the bill as proposed awarded a 60 percent state tax credit for donations to the CATCF in 2012. The tax credit was to be reduced by 50 percent in both 2015 and 2016, after which point the program would end. The program fund was capped at $500 million annually.

Applying the analysis discussed above in Section III, a gift to the CATCF would generate two significant tax benefits for the donor. First, the taxpayer would be entitled to a state income tax credit for 60 percent of the amount of the gift (assuming a gift in 2014). Second, applying the logic of ILM 201105010, the taxpayer would be entitled to claim a charitable contribution deduction on her federal income tax return for the full amount of the gift.

To illustrate, assume that Elena makes a qualifying gift to the CATCF of $100,000, which under S.B. 284 would entitle her to a California state income tax credit of $60,000. Assuming for the moment that Elena is not subject to the federal AMT, her gift should (1) entitle her to a charitable contribution deduction of $100,000 on her federal income tax return, and (2) reduce her California state income tax liability by $60,000, which will (3) reduce her federal deduction for state/local taxes by $60,000. The net effect is that Elena’s payments to California increase by $40,000 and her overall federal deductions increase by $40,000. We will refer to the $40,000 figure as the “true gift” portion of her total payment to the state and the $60,000 portion as a “faux gift” because it is effectively refunded to her through the state tax credit. Elena’s federal income tax burden drops by $15,840, which is simply the $40,000 true gift portion of her donation multiplied by the top rate of 39.6 percent. Note that this result is no different from the benefit Elena would receive by making a charitable donation of $40,000 to the state of California.

Algebraically, the net after-tax cost of the gift to Elena can be stated as:

\[ G(1 - f)(1 - s) \]

or

\[ G(1 - f - s + fs) \]

where \( G \) is the gross amount of the gift, \( f \) is the federal marginal tax rate, and \( s \) is the state credit percentage. Assuming a federal rate of 39.6 percent and applying the CATCF credit percentage of 60 percent, the after-tax cost of a $100,000 gift is $100,000 x (1-0.396)(1-0.6), or $24,160. Intuitively, that can be described as a combination of: (1) a gross cash outflow of $100,000; (2) minus $39,600 in federal tax savings from the federal charitable contribution deduction of $100,000; (3) minus $60,000 in state tax savings from the state charitable tax credit at a 60 percent credit percentage; (4) plus $23,760 in increased federal taxes arising from the $60,000 reduction in the federal deduction for state and local taxes.

The key is that even though Elena is saving $39,600 in federal taxes by virtue of her $100,000 charitable contribution deduction, she is also increasing her federal tax payments by $23,760 by virtue of losing $60,000 in deductions for state and local taxes. In effect, because Elena loses $60,000 worth of California state and local tax deductions on her federal return, she ends up deducting only the true gift portion of her donation. The faux gift portion is effectively rendered nondeductible by the $60,000 reduction in the deduction for state and local taxes.

If Elena is subject to the federal AMT, the $100,000 gift to the CATCF will entitle her to a charitable contribution deduction of $100,000 on her federal income tax return and reduce her state income tax liability by $60,000. Significantly, however, the reduction in state income tax liability in that scenario has no effect on Elena’s state and local tax deduction because state and local taxes are not deductible for AMT payers. The result is that Elena deducts not only the $40,000 true gift portion of her donation (saving her $11,200 in federal income taxes) but also the $60,000 faux gift portion (saving her $16,800 in federal income taxes). As a result, her total federal tax savings will be $28,000 — that is, $100,000 gross gift multiplied by a marginal tax rate of 28 percent (the top rate for AMT payers).

Algebraically, the net after-tax cost of the gift to Elena when subject to the AMT can be stated as:

\[ G(1 - f - s) \]

which differs from equation (2) above in that it does not feature the “+ fs” term that represents the federal tax increase attributable to the loss of state and local tax deductions that an itemizing taxpayer would normally experience as a consequence of a reduced state income tax burden. But recall that in the non-AMT example it was the loss of state and local deductions that effectively rendered the faux gift portion of the donation nondeductible. Because an AMT payer has no state and local tax deductions to lose, there is no mechanism by which her federal deductions are effectively limited to the true gift portion of the donation.

Based on that analysis, we can see that an AMT payer making a $100,000 donation to the CATCF special fund has a net out-of-pocket cost of only $12,000 — that is, $100,000 minus $28,000 (in federal tax savings) minus $60,000 (in state tax savings). Clearly, the tax savings for

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40 Id. at section 1(a)(1)(A).
41 Id. at section 1(b)(1).
that type of donation are far more than the tax savings normally arising from charitable gifts. AMT payers willing to make a gross gift of $1 to Cal Grants will be reimbursed a total of $0.88, consisting of $0.60 from the state of California and $0.28 from the federal governments.

As structured, S.B. 284 is a powerful "matching grant" program that if enacted is likely to generate significant new funds for the Cal Grants program. Indeed, the matching rates are so generous that it is also likely to draw charitable dollars away from other worthy causes. Even so, it is worth noting that the program could be made even more attractive to potential donors. The most obvious way to do that would be to increase the credit percentage. Any credit percentage greater than 72 percent would ensure that donors experience no out-of-pocket costs for their donations. In states with charitable tax credit programs already in place, tax planners are beginning to catch on. One website describing Arizona's tax credit for school tuition organizations notes that if you are subject to the AMT, the tax benefits received exceed the out-of-pocket cost.42

B. Expanding the (Potential) Benefits of S.B. 284

The two examples just described — one involving an itemizing taxpayer not subject to the AMT and the other featuring a taxpayer subject to the AMT — reveal that a state income tax credit of the sort incorporated in S.B. 284 is likely to be most attractive to taxpayers subject to the AMT, which includes roughly 750,000 federal tax returns filed from California in 2010. Yet the potential benefit of a CATCF need not be limited to AMT payers. Building from the analysis in Section III, we note two possible changes to the CATCF framework that could expand the reach of its benefits.

First, to the extent that the tax credit is transferable, the Tax Court's decision in Tempel suggests that a sale of the credit will give rise to capital gains rather than ordinary income. As a result, a taxpayer not subject to the AMT actually would be better off selling the credit (after holding it for more than a year to qualify for long-term capital gains) instead of using it herself. As noted above, using the credit results in a lower federal deduction for state and local taxes — that is, the "+ f(s)" term in equation (2). By selling the credit after a year, the taxpayer experiences a different and smaller federal tax increase (that can be portrayed by replacing the "+ f(s)" term in equation (2) with "+ ks" where k is the federal capital gains rate) than if she uses the credit herself.

As an example, assume that Peter donates $100,000 to the CATCF fund, which entitles him to a $60,000 credit that he sells 13 months later for $58,000. Under the logic of ILM 201105010, he should be able to claim a deduction of $100,000 for the donation, which assuming a federal tax rate of 39.6 percent saves him $39,600 in federal income taxes. For example, if the state were to grant a 60 percent sales tax credit instead of an income tax credit, such a program would likely be attractive to AMT payers and even more so to high-bracket itemizing taxpayers not subject to the AMT. That is because sales taxes are generally not deductible for purposes of the federal income tax.

For example, if Lakshmi were to donate $100,000 and therefore qualify for a $60,000 sales tax credit, she would be able to claim a $100,000 charitable contribution deduction under the logic of ILM 201105010 and reduce her state sales tax payments by $60,000. Although sales tax credits are far less common than income tax credits, they are not unheard of. Perhaps the sales tax credit could take the form of a debit card that the taxpayer could use to make sales tax payments when making taxable purchases.

Lakshmi's reduction in state sales tax liability should have no effect on her federal income tax liability because sales taxes are generally not deductible. But note that she is effectively making sales taxes deductible by smuggling them into her $100,000 charitable contribution deduction. As a result of her $100,000 gift, Lakshmi's federal income tax burden should be reduced by $39,600 (assuming a 39.6 percent federal tax rate). In form, Lakshmi is donating $100,000 to a good cause. In substance, one might say that she is donating $40,000 to a good cause and purchasing a $60,000 prepaid sales tax debit card. Because of ILM 201105010, both amounts appear as deductions on her federal income tax return in the form of a $100,000 charitable gift, saving her $39,600 in federal income taxes.

As with our other examples, the benefit can be made even more generous by increasing the credit percentage. For example, if we assume a state sales tax credit of 75 percent for donations to a state agency, anyone subject to a federal marginal tax rate greater than 25 percent, whether subject to the AMT or not, would actually profit by making a gift to the state agency. We hasten to emphasize that this "profit" comes at the expense of the federal treasury and thus has in more common with the gains enjoyed by Bonnie and Clyde than by a small business owner or productive entrepreneur. Still, given the IRS's position in ILM 201105010, it is understandable why a state may wish to partner with its taxpayers to promote charitable gifts to state agencies.

V. Conclusion

The opportunities for California to make its tax code more efficient from a state perspective might well be considered bad policy from a national viewpoint. If we were advising Congress, we might suggest that those opportunities result from flaws at the national level. However, members of the State Legislature are custodians of state welfare, particularly in an era of state budgetary distress. Thus, it behooves the Legislature at least to investigate potential adjustments to California state tax arrangements that would benefit the state by bringing in more federal dollars.
This joint report reflects insights from many tax scholars, practitioners and analysts. The primary drafters are Ari Glogower, David Kamin, Rebecca Kysar, and Darien Shanske. All errors are our own.
Executive Summary

This report describes various tax games, roadblocks and glitches in the tax legislation currently before Congress.

The complex rules proposed in the House and Senate bills will allow new tax games and planning opportunities for well-advised taxpayers, which will result in unanticipated consequences and costs. These costs may not currently be fully reflected in official estimates already showing the bills adding over $1 trillion to the deficit in the coming decade. Other proposed changes will encounter legal roadblocks, that will jeopardize critical elements of the legislation. Finally, in other cases, technical glitches in the legislation may improperly and haphazardly penalize or benefit individual and corporate taxpayers.

This report is not intended as a comprehensive list of all possible problems with the drafting and design of the House and Senate bills. Rather, this report highlights particular areas of concern that have been identified by a number of leading tax academics, practitioners, and analysts.

In particular, the report highlights problems with the bill in the following areas:

- **Using Corporations as Tax Shelters**

  If the corporate tax rate is reduced in the absence of effective anti-abuse measures, taxpayers may be able to transform corporations into tax-sheltered savings vehicles through a variety of strategies. For instance, at the most extreme, it may be possible to shield labor income in a C-corporation so that it faces a final tax rate of only 20%.

- **Pass-Through Eligibility Games**

  Taxpayers may be able to circumvent the limitations on eligibility for the special tax treatment of pass-through businesses. For instance, under the Senate bill, many employees—such as law firm associates—could become partners in new pass-throughs and potentially take full advantage of the special tax treatment.

- **Restructuring State and Local Taxes to Maintain Deductibility**

  The denial of the deduction for state and local taxes will incentivize these jurisdictions to restructure their forms of revenue collection to avoid this change. This could undercut one of the largest revenue raisers in the entire bill.
• **International Games, Roadblocks, and Glitches**

The complex rules intended to exempt foreign income of domestic corporations from U.S. taxation present a variety of tax planning and avoidance opportunities. For instance, one provision would encourage sales of products abroad, only for those products to be sold right back into the United States. Furthermore, several of these rules are likely to be non-compliant with both World Trade Organization rules for international trade and our network of bilateral tax treaties. Some of these rules also create perverse economic incentives, like advantaging foreign over domestic manufacturers.

• **Arbitrage Money Machines**

The variety of tax rates imposed on different forms of business income in different years invite arbitrage strategies, whereby taxpayers can achieve an economic benefit solely based on the timing and assignment of their income and deductions.

• **Other Glitches**

Other glitches in the proposed bills would haphazardly penalize taxpayers. For example, the reintroduction of the corporate AMT at the 20% rate in the Senate bill would vitiate key tax incentives and the basic structure of the international reforms. The proposal in the House bill to tax capital contributions to entities could penalize taxpayers for no justifiable reason.
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I. Introduction

The tax legislation now before Congress was written quickly, leaving legislators and the public little time to analyze its provisions—many of which are highly complex. Tax lawyers and accountants are already preparing to exploit ambiguous and poorly drafted provisions in the bill. Because of these tax-planning opportunities, it is likely that the actual cost of this legislation will exceed the current projections of over $1 trillion.

In a handful of cases (such as the last minute addition of the corporate AMT), some of the unintended or opaque consequences of the bill might cut the other direction—and raise taxes on businesses and individuals in unexpected ways. But we suspect that in the end, the wealthy and well-advised will benefit disproportionately from these errors of oversight and haste. The corporate AMT mistake will almost certainly be corrected according to reports, while many of the largest loopholes may remain in the final bill. Thus, unless Congress makes a number of substantial changes, the final legislation could deliver much larger benefits to some of the best off (and their advisors) than even current estimates might suggest.

The bills from the two houses are now headed to conference committee. As Congress tries to negotiate final legislation, we offer a list covering three categories: (1) Tax games. These describe some of the key areas where we believe tax planning is likely to occur. (2) Roadblocks. These include areas in which the legislation may interfere with important non-tax policies and encounter legal roadblocks as a result (e.g., by causing the United States to violate international trade law). (3) Glitches. These are mistakes or ambiguity in the drafting that could lead to uncertainty and haphazard increases or decreases in taxes.

Congress should immediately reconsider its approach. Put simply, these bills are right now riddled with problems and, especially in light of likely future gridlock in Washington, it is very important to get this right the first time.

This document reflects the collective work of a number of tax scholars, practitioners and analysts, and represents our different areas of expertise and viewpoints. There are places where some of us might even disagree with others on the proper interpretation of a provision and the wisdom of a policy, but we all agree that the areas described below urgently need more attention.

This is also not a comprehensive analysis. That would take much more time and space than we now have, and, on a number of these topics, we are confident that more time and more writing will only lead to identification of more such problems.

Many of us also object to the basic structure and motives of the legislation: a revenue-losing bill that directs disproportionate benefits to businesses and wealthy investors, and is expected to leave low and middle income Americans worse off in the end. But our present concern is more specific. This report focuses on areas where complexity, variations in tax rates, poor drafting,
and a failure to consider our international obligations could lead to uncertainty, additional windfalls for sophisticated taxpayers, and significant costs to everyone else. We also highlight areas where these factors—and others—are likely to dramatically drive up the true revenue costs of these provisions.

We begin with a description of some of the relevant tax games, roadblocks, and glitches that would arise from the Senate and House bills, and then describe a number of the more complex areas further in the Appendix.

II. Tax Games, Roadblocks, and Glitches

A. Using Corporations as Tax Shelters

Both the House and Senate bills would tax corporate income at a flat rate of 20%. Without effective anti-abuse provisions, this change would encourage taxpayers to use the corporate form as a tax-sheltered savings vehicle.

The basic advantage to investing through a corporation is that income is not currently taxed to the investor. The cost of investing through a corporation, however, is the “double tax” on income, both to the corporation (when income is earned) and to the investors (upon a distribution or sale of their corporate interest). If, however, the corporate tax is reduced, taxpayers can use the corporate form to shelter their income from tax.

In combination, the 20% corporate rate and the later second layer of capital gains or dividend tax can produce a rate roughly equivalent to the top ordinary rate. But, deferring or potentially even eliminating the second layer of tax then makes the C-corporation preferable to simply earning the income as an individual subject to the top rate. Corporations can also deduct the state and local income taxes that individuals cannot, which will provide another incentive for individuals to form corporations.

The benefit of a low corporate tax rate is compounded by other structural features of the income tax. Both the House and Senate bills would preserve the “basis step-up” upon a taxpayer’s death. As a result, investment income held through a corporation can first accrue at a low rate during the investor’s life. The investor’s heirs can then inherit the corporate interest with a basis equal to its fair market value, and thereby eliminate the second individual layer of tax. There are also other methods described below for avoiding the second layer of tax.
As analysts including Mike Schler, Adam Looney, and Ed Kleinbard have described, a low corporate tax rate invites myriad planning opportunities. Here are a few (with much of this analysis a credit to their work). These examples are described in greater detail in the appendix.

- **Stuffing the C-corp.** The simplest strategy is for a taxpayer to invest through a corporation so her investment income accrues at the lower corporate rate. This strategy will be particularly advantageous in the case of fixed income investments (like interest on bonds), which would be taxed at rates of up to 43.4%, more than twice the rate of tax on that same income when held through a corporation. However, taxpayers can achieve a significant benefit in the case of domestic equity investments as well, because dividends received at the corporate level will now be taxed at a reduced 10% rate as compared with a 23.8% rate for dividends received outside the corporation. These benefit will be compounded if the taxpayer passes on the interest to her heirs or uses other methods described below for avoiding the second layer of tax.

- **Transforming labor income into corporate profits.** Taxpayers will relatively easily be able to shield their labor income from the high ordinary tax rate by simply setting up a corporation (or checking the box so that a partnership or other entity is treated as a corporation for tax purposes), and having their income accrue in the form of corporate profits. This has the potential to permanently shield labor income from a higher rate if combined with step up in basis or other methods for avoiding the second layer of tax.

- **Salaries in closely held corporations.** Relatedly, shareholder-employees in a closely held corporation can achieve the same effect by reducing their wages paid out by the corporation, thereby increasing the corporation’s retained profits. In effect the shareholder-employees derive the benefit of immediately reinvesting their pre-individual-

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2 As Mike Schler notes, general anti-abuse rules, such as assignment of income principles and the economic substance doctrine, may discourage the most severe abuses. There are other anti-abuse rules that would govern as well, such as those governing retained earnings and personal holding companies. However, the existing rules are notoriously porous and easy to evade. Further, even better anti-abuse rules cannot effectively police all tax planning behavior and would be costly for the IRS to enforce. For further discussion, see the Appendix. See also Kleinbard, *supra* note 1.

3 The 39.6% top marginal rate plus the 3.8% NIT.

4 The 10% rate results because the House and Senate bills both allow corporations a 50% deduction for dividends received from other domestic corporations. The resulting rate is 20% x 50% = 10%, which is less than half the top rate on qualified dividends paid to individuals (20% plus the 3.8% NIT).
tax labor income within the corporation, where it can accrue returns at the lower corporate rate.

- **Avoiding the second layer of tax.** The tax savings from using the C-corporation become super-charged if the second layer of tax is avoided. This can be done a number of ways:
  
  o **Step up in basis.** As already noted, the C-corporation stock can be held until death at which point the second level of tax is entirely wiped out due to “step up” in basis.

  o **Roth retirement accounts.** In effect, a corporation taxed at a low rate operates as a “quasi-Roth” account. If the taxpayer is in fact saving for retirement, however, even greater planning opportunities arise. A taxpayer is allowed to hold shares in a closely held corporation in her Roth account, which exempts future investment returns from tax. If the taxpayer is also an employee of the corporation, she may forego a portion of her salary in exchange for higher corporate profits that will be completely exempt from individual tax. In a Roth account (and assuming distributions occur in retirement) the second level of tax would never be imposed.

  o **Lower tax rates in retirement.** Even if the corporate interest is not held in a Roth account, the taxpayer may similarly reduce the individual level tax by waiting until retirement to receive distributions, when the taxpayer may be taxed at lower marginal rates.

  o **Other strategies.** There are also other strategies for avoiding the second layer of tax—such as the partial exclusion for gains on investment in certain “small business” stock.

Of course, a taxpayer could engage in any of these activities now under current law. The key difference is that the current cost of the relatively high corporate tax limits the benefit from these strategies. The current structure of the income tax is poorly equipped to address a scenario in which corporations are taxed at a much lower rate than individuals. If Congress intends to transform the corporate form into a tax-preferred savings vehicle, new rules are required to prevent abuse. Unfortunately, such rules are sorely missing from the proposed House and Senate bills.

**Solutions:** Planning opportunities will arise whenever the corporate tax rate is significantly less than the individual rate. Smaller fixes could scale back the most egregious opportunities for abuse, but more aggressive measures could create other inefficiencies.

- **Eliminate the basis step-up.** Eliminating the step-up in basis at death would prevent taxpayers from completely avoiding the individual-level tax on corporate investments.
held for their entire lifetime. This partial solution, while an important step, would preserve significant tax planning opportunities.

- **Further reduce the dividends received deduction for non-affiliates.** While the House and Senate bills both reduce the deduction for dividends received from an unaffiliated domestic corporation (from 70% to 50%), this still results in a very low 10% corporate tax rate on dividends received. Further reducing or eliminating the deduction for dividends received from unaffiliated domestic corporations would make it less attractive for taxpayers to stuff C-corps with equities, while not interfering with the planning decisions of C-corporations that use affiliated subsidiaries for business purposes.

- **Anti-abuse rules.** Congress and Treasury could tighten general anti-abuse rules in the tax law, such as the personal holding company and accumulated earnings tax provisions, but overly restrictive limitations would interfere with a corporation’s legitimate business decisions as to when and how to deploy capital. Limitations on the ability to incorporate for tax purposes would require complex rulemaking and line-drawing.

- **A comprehensive solution.** If Congress is committed to reducing the corporate tax rate well below the top individual rate, more fundamental structural changes to the income tax are necessary to avoid the gaming opportunities described above. Corporate earnings could be taxed currently at the individual level through either pass-through treatment (for small closely held corporations) or mark-to-market taxation (for large publicly traded corporations). This change would in turn allow for closing the rate gap between capital and labor income. This package of reforms would neutralize the benefits of investing through corporations, and allow for the reduction or even the elimination of the corporate tax.

### B. Pass-Through Eligibility Games

The lower tax rate on pass-through income provides special tax relief to a swath of business owners, with most of the benefit concentrated among those with the highest incomes. The provisions in the bills from both houses are complicated, and seem to intentionally benefit an array of special interests and particular types of capital owners. The various lines drawn by the provisions will result in substantial tax planning and lower taxes for anyone able to characterize their livelihood as an eligible business rather than as a job.

These games are separate from those that can be played with C-corporations. In some cases, it will be more advantageous to take advantage of pass-through rates; in other cases, a C-corporation shelter would be preferable. Importantly, it will be the taxpayer’s choice, and, either
way, the result is that the taxpayer will avoid tax at the top individual rate—and will instead enjoy a lower, preferential rate, whether via a C-corporation or pass-through.

In particular, taxpayers may be able to game the pass-through provisions through the following strategies, each of which is described in greater detail in the Appendix:5

- **Law firm associates, LLC.** Under the Senate bill, there is potentially a major problem as drafted: Employees may be able to benefit from the pass-through provision by forming a pass-through of which they are an owner. To achieve the tax savings, no longer be an employee (who cannot benefit from the provision); instead be an owner (who can benefit from the provision). For example, law firm associates (and other employees of the firm) should no longer be mere associates. They should instead be partners in Associates, LLC—a separate partnership paid to provide services to the original firm.6 Their “profit share”—in lieu of salary—from Associates, LLC would then be given the special low pass-through rate. There are restrictions on lawyers—since they provide a personal service, which is disfavored in the bill—from benefiting from the special pass-through rate, but those restrictions would not apply to these associates. So long as the associate (or really partner in Associates, LLC) makes less than $500,000 in taxable income (for a married couple) or $250,000 (for a single individual), they would be fully eligible. And that covers a lot of law firm associates, not to mention many other people who are now employees—but who may not be for long.

The same loophole might even apply to the “self-employed.” This could further expand revenue loss and encourage people, when able, to either mischaracterize or rearrange relationships to be independent contractors rather than employees.

It is possible that the Senate does not intend the provision to benefit service providers like this. An alternative interpretation—and a possible one based on existing doctrine and the legislative language—is that these service providers won’t benefit to the extent the profits allocated to them represent “reasonable compensation” for their services. At present, though, this limitation is inconsistent with parts of the legislative history, and the text can be reasonably read to provide otherwise. The legal details are described in the Appendix. If Congress does not intend to write in such a massive loophole into the bill, it should act now to clarify—and not hope the IRS will staunch what could be a major bleed in revenue and a giveaway disproportionately benefiting those with high incomes.

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5 These examples all come from analysis by Dan Shaviro, Mike Schler, and Victor Fleischer, and, in some cases, all of them. For Dan Shaviro’s analysis of the pass-through loophole, see here. See also Schler, supra note 1, and Victor Fleischer here.

6 The associates could also be made non-voting partners in the original partnership itself, but, as David Miller points out, firms are sensitive to issues like “profits per partner” and so would probably prefer the associates be separated. This strategy might also reduce the risk of the profit shares for the associates being deemed “guaranteed payments,” which would not benefit from the lower pass-through rate.
- **Go passive or get some capital.** Under the House bill, the key to the preference is not just to be an owner but, in addition, to be a passive owner rather than an active worker at the firm—effectively granting a subsidy to those who work less. Taxpayers would respond accordingly, by appearing to reduce their active involvement in the business. If it’s a family owned business, owners could make sure no one family member spends too much time running the firm. Or an owner could swap ownership interests with someone else running another firm—and be passive investors in each other’s firms. Or owners could split apart lines of business—and the time the owner spends in each—so that the owner does not “materially participate” in any single business. Another option is to get capital in the firm, which can allow owners to apply the lower pass-through rate to other income—since the legislation assumes a very high rate of return to such investments. Lawyers and doctors should buy their own buildings as a result (unless they’re a large firm, in which case there may be an even more tax favored way to hold the building).

- **Split apart—or the famous athlete’s brand company.** As the Washington Post points out, some people who are subject to the line of business restrictions—which denies the special pass-through rate to lawyers, doctors, athletes, and others (to all in the House bill and above certain income thresholds in the Senate bill)—might still be able to benefit. One strategy is to split off the brand name (such as the brand of a famous athlete or a major law firm). Put the brand in a separate pass-through which manages the brand but does not engage in the restricted business. The result is that a nice swath of income—the income attributable to the “brand” rather than the restricted services—gets the lower pass-through rate.

Under the Senate bill, there still might be a problem in taking the pass-through deduction—the firm would need enough employee wages. Firms that don’t pay wages can’t take the deduction. One workaround would be to hire some employees, and perhaps even only one, such as the athlete. The athlete could collect just enough wages through this company to take the pass-through deduction on the rest of the income.

**Solution:** The best answer would be to eliminate the pass-through provisions entirely. As many have described, the favorable pass-through provisions in the House and Senate bills are unjustified and inherently subject to such gaming and planning. At best, the provisions disproportionately and perversely benefit passive investors. If Congress wants to keep a preferential rate using the basic structures now on the table, it should strengthen the guardrails to avoid a much larger giveaway than lawmakers may intend to offer:

- Under the Senate bill, lawmakers should clarify that people providing labor services cannot fully take advantage of the pass-through deduction by simply forming as a partnership or being independent contractors (taking some of the juice out of the Law Firm Associate LLC game). They should at least be required to exclude any
partnership profits or self-employed business earnings that represent “reasonable compensation” for services from the benefit.

- Under the Senate bill, lawmakers should strengthen the Senate’s requirement that a pass-through must pay wages to get the deduction (making the Famous Athlete’s Brand Company game harder). Someone shouldn’t be able to pay salary to themselves for instance to generate eligibility. The requirement of paying salary should also be adopted as a guardrail in House version of the legislation.

- Under the House bill, the assumed return of capital should be lowered so that capital investments (like a building) can’t be used to give other income (like from lawyering) the lower, pass-through rate.

C. Restructuring State and Local Taxes (SALT) to Maintain Deductibility

Under both the House and Senate bills, the itemized deduction for state and local taxes for individuals is limited to $10,000 and is only available for property taxes. This change is among the largest revenue raisers in the entire legislation, though we believe estimates do not currently take into account the likely state response. There are numerous ways for states and localities to reshape their tax systems so as to respond to this change and retain the benefit of the deduction for their taxpayers. The key is to shift toward deductible taxes without changing significantly who pays the taxes as an economic matter. SALT is being scored a big revenue raiser, but administrative adjustments—some relatively small—that allow state taxpayers to retain the SALT benefit must be anticipated.

As described further below, many of us believe Congress should retain much, if not all, of the SALT deduction; however, if Congress plans to limits the deduction—and if this change is expected pay for a large portion of the bill—the response of state and local governments should be taken into account.

In particular, states and localities could use the following deductible taxes in place of non-deductible individual income taxes:7

- **Property taxes.** One way for states to achieve this is by shifting to use of the property tax. The liquidity impact on taxpayers of a shift to property taxes can be mitigated by circuit breakers administered through a state’s income tax—essentially, reducing income tax liability in exchange for higher property taxes. Such responses would effectively

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7 The analysis of SALT tax planning arising from the tax bill represents a summary/expansion of previous analysis done by Darien Shanske, Daniel Hemel, David Kamin, Manoj Viswanathan, Kirk Stark, and Phillip Blackman.
allow taxpayers to deduct the full amount of state and local property and income taxes, up to the $10,000 cap.

- **Employee payroll taxes.** Another tax which could be used in place of a state income tax is a state payroll tax with legal incidence on the employer. Since the tax is levied on the employer, the employer would still be able to deduct the taxes—even as it would function, in economic terms, very similarly to an income tax imposed directly on the employee.

- **Charitable gifts.** State and local governments can make it easier for taxpayers to make charitable donations to the jurisdictions, which would then be credited against state income taxes.

- **Business “franchise” taxes on pass-throughs.** Business “franchise” taxes—taxes imposed on the business entity—appear to remain deductible even if imposed on pass-throughs (and so deducted by the individual). These are sometimes based on the capital or net worth of the firm, or, in the case of New York City, even on the income of the firm (though, unlike with other franchise taxes, it is not clear if one imposed explicitly on business income would remain deductible to individuals). States could shift to such franchise taxes and then link them up to their individual income tax systems—for instance, reducing individual income tax liability based on franchise tax payments.

**Solutions:** There are no easy solutions to prevent restructuring to maintain SALT deductibility. Three general directions are possible:

- **Reduce or eliminate the cutback.** A number of us believe that at least a partial deduction for state and local taxes is justified. Simply reducing or eliminating the cutback would lessen the incentive for states to restructure their revenue collection mechanisms.

- **Use a realistic revenue estimate and offset the additional cost.** If a cap at the level in the current proposals is preserved, revenue estimates should be adjusted to reflect states and localities responding to maintain deductibility—and Congress should be forced to come up with other revenue raisers to make its budget math work.

- **Broaden the scope and phase in the cap.** To reduce the states’ incentive to game the cutback, Congress could set a single cap on all possible state and local taxes rather than permit just one kind of tax to be deducted. The cap should also be set higher than the proposed $10,000 limit and phased in at higher income levels to reduce the gaming incentive. Implementing a single integrated cap and a phase-in schedule, however, could require additional complexity, particularly in light of different revenue-raising instruments used in different jurisdictions.
D. International Games, Roadblocks, and Glitches

The international provisions are among the most complex in the legislation. They deserve serious attention and, as illustrated below, present numerous gaming opportunities, adverse consequences under international law, and undesirable incentives to locate investment and assets abroad. To be sure, the current system also is the subject of considerable tax planning, avoidance, and inefficiency. But, the proposed system will introduce significant new problems.\(^8\)

The basic structure of the international reform is to (1) exempt foreign income of U.S. corporations from taxation in the United States (a territorial system); (2) backstop the territorial system with a 10% “minimum tax” on foreign-source intangible income (the GILTI regime in the Senate and the high profit foreign-subsidiary regime in the House); (3) provide a special low rate on export income in the United States (the FDII regime, in the Senate bill only); and (4) target profit-stripping by foreign firms operating in the United States (the excise tax in the House and the BEAT in the Senate).\(^9\)

Here are a few examples of the problems with these reforms, with supplemental analysis in the Appendix:

- **The minimum tax formula induces companies to locate real assets and investment offshore.** Congress is right to be worried that U.S. corporations are incentivized to shift profits out of the United States, and especially through intangibles. This dynamic is potentially aggravated by the exemption of foreign source profits from taxation under the new system. However, the minimum tax, as structured, is highly problematic. It exempts a deemed 10% return on tangible assets, measured by tax basis. This pushes U.S. firms in the direction of locating real assets (and accompanying jobs) overseas rather than domestically. Furthermore, because the minimum tax is applied on a global basis (rather than country-by-country), firms are also incentivized to locate investment in low tax countries and blend that income with income from high tax countries.

- **The minimum tax on intangible income can be avoided through leveraging.** A firm can load up on tangible property abroad—potentially just borrowing to buy assets—and thereby shield “intangible” income (potentially stripped out of the United States) from taxation.\(^10\)

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8 This section on international taxation reflects the work and insights of Rebecca Kysar.

9 This discussion ignores the unintended effects on the international provisions from the reinstatement of the corporate AMT in the Senate bill, an issue that is flagged below and likely to be resolved in conference.

10 Thanks to Mitchell Kane for this insight on using investment in tangible assets to shield intangible income. Mike Schler also discussed the leveraging point in his article. Schler, *supra* note 1, at 44.
• Solutions: The problem with loading up on tangible assets could be addressed by, among other solutions, applying the minimum tax to all foreign source (non-subpart F) income, without any exemption for a return to tangible assets. The problem of blending could be addressed by moving to a country-by-country minimum tax rather than one done on a global basis. Both of these options, however, could be critiqued as moving too far in the direction of worldwide taxation. If this is a concern, the minimum tax could be imposed at a lower rate. Caution should be taken in lowering the rate, however, since this would impact revenues and would also lead to increased profit shifting and base erosion by widening the disparity between the domestic rate and the foreign minimum rate.

A less drastic option would be for debt to reduce tangible asset basis to some degree for purposes of the minimum tax. Alternatively, one could ignore debt and instead exempt an amount equal to a risk-free rate of return to the equity in each CFC. If one does not limit the ability to use leverage, then at the very least the 10% deemed return on tangible asset basis could be set at a lower percentage rate.

• Problems with the special low rate on export income associated with intangibles: roundtripping products, advantaging foreign over domestic manufacturers, and WTO non-compliance. The special low rate of 12.5% in the Senate bill for export income is intended to encourage firms to keep and develop intangible property in the United States. But, it could easily undermine the U.S. tax base while also being an unstable solution due to possible WTO non-compliance. First, corporations can play a seemingly easy game to get the special low rate on exports, even for sales actually occurring in the United States. They can roundtrip products. A corporation is encouraged to sell abroad, only to have those products then sold right back home; the result is an apparently low special rate.

The low rate also encourages firms to sell unfinished products to foreign manufacturers rather than domestic manufacturers, since the former transaction would get the low rate and the latter would not. This is a perverse economic incentive in a bill purportedly dedicated to increasing investment and jobs in the United States.

Further, although the export subsidy regime was touted as promoting neutrality in the decision of where to locate IP, foreign intangible income faces a lower 10% rate in the Senate bill, which means that firms may still choose to locate IP abroad. This disparity in rates leads to an unstable and peculiar result: We tax the item we want to favor (exports) more onerously than the item we want to disfavor (foreign intangible income).11

11 Thanks to Mitchell Kane for this point.
Finally, this low rate on export income likely runs afoul of WTO rules, and so is not a stable reform. The way that the rate is calculated means that the greater the U.S. taxpayer’s income from exports, the more of its income gets taxed at the special low rate. As such, it is likely an illegal export subsidy in violation of the United States’ WTO obligations.

- **Solutions:** Especially in light of these incentives, the likely incompatibility with WTO rules, and the lack of evidence as to whether patent boxes increase R&D and employment, the better course of action is to drop this export incentive entirely. If the committee wishes to retain the special rate, to effectuate the purported goal of neutralizing investment decisions, the minimum tax rate should be raised to at least 12.5%. At minimum, the law should establish roundtripping rules that prevent easy gaming of the export subsidy (though perverse economic incentives would remain).

- **Problems with inbound provisions meant to prevent earnings stripping using foreign affiliates, especially by non-U.S. corporations: WTO and tax treaty non-compliance.** The problem of earnings stripping using deductible payments between a U.S. subsidiary and a related foreign entity is a serious one, especially among non-U.S. corporations which aren’t currently subject to rules restricting this strategy. Both the House and Senate bills try to address this problem by imposing a tax liability on such deductible payments to a related foreign entity. However, both provisions could be characterized as a forbidden charge on importation or a discriminatory internal tax—in violation of the WTO rules. Additionally, they both pose problems for our network of bilateral tax treaties, especially the House version for reasons discussed further in the Appendix.

- **Challenges:** Solving the myriad problems under international law is not easy. The United States should anticipate immediate WTO challenges to the inbound regimes. The United States should also anticipate pressure from our treaty partners to scale back the inbound regime via treaty, and the revenue estimators should anticipate this reaction. When it comes to tax treaty obligations, the Senate provision is superior to the House one, but, in either case, the United States should be prepared to devote significant resources to litigating and renegotiating our international agreements.

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E. Arbitrage Money Machines: Gaming the Rates Differentials on Business Income

The variety of tax rates imposed on business income do not just generate incentive to try to get income taxed at the lowest rate possible (though it does that); it also incentivizes “arbitraging” to generate income taxed at low rates and related deductions taken against high rate income. The result is a money-machine, with the government essentially paying taxpayers who successfully pull off such transactions. This can be done in a variety of ways under the legislation. For instance: \(^{13}\)

- **High rate in 2018, low rate in 2019** (or who wants to have fun with equipment!). In the Senate legislation, the corporate rate reduction from 35% to 20% is delayed for a year, from 2018 to 2019. As Dan Shaviro describes, this means that corporations predictably know that costs will be written off against a high rate in 2018 (35%), and income will be included at a low rate (20%) in 2019 and thereafter. It’s an easy arbitrage opportunity, especially in combination with expensing in 2018. With appropriate counterparties, firms can buy equipment in 2018, place that equipment in service, and even then just sell it in 2019 at a gain. In doing so, they’d take advantage of a 15 percentage point rate differential, writing off against a higher rate and including the income at a lower rate.

- **Profits before losses in pass-throughs.** In the pass-through context, Congress recognized there was a potential arbitrage opportunity, but only came up with a partial solution. In particular, tax writers understood that it would be a problem if pass-through losses were written off against ordinary income at a high rate, while pass-through income was then taxed at a low rate under the new rules. However, Congress’s solution was not to prevent pass-through losses from being deducted against ordinary rate income. Rather, if the losses come first, there is then a later restriction on how much pass-through income is subject to the preferential rate to the extent of those losses. This then permits a one-time way around the rule: time the income to come first and losses second. The result: the tax arbitrage works as income is included at a low rate and the eventual losses are deductible against a high rate and without a later detriment. In the Senate bill, this game would be limited to some degree by the cap on pass-through losses (limit of $500,000 for a married couple/$250,000 for a single individual of such losses applied against other income), and the IRS could try to move to recapture some of the benefit—but it is certainly subject to more mischief than immediately limiting the rate at which the losses are deductible.

- **Deals among firms.** There will often be a variety of firms in business with one another, whether through partnerships or otherwise. To the degree that there are simply more

\(^{13}\) This discussion represents a summary of analysis done by Daniel Shaviro, Mike Schler, and David Kamin, among others.
entities with more variance in tax rates, there is greater opportunity to try to assign losses/deductions (for tax purposes) to the one taking those deductions against higher rate income while assigning income to the opposite. There are rules meant to restrict such maneuvers, but they already occur nonetheless, especially in the partnership context but in others too.

- **Solution:** The solution is fewer of the rate differentials that generate these kinds of arbitrage opportunities. Do not have the predictable rate cliff in 2019 that will generate so many games beforehand; do not apply special tax rates to pass-through income but to the extent that you do, make sure related losses must be taken against that rate.

F. **Other Glitches Which Could Haphazardly Penalize Taxpayers**

The haste with which these bills were written have left in a variety of other glitches and problems, some of which may haphazardly penalize taxpayers. For instance:

- **Accidental corporate AMT in the Senate bill.** In the Senate bill, the corporate AMT was (now infamously) retained at the last minute before passage. The problem is that the corporate AMT's tax rate—of 20%—is the same as the new regular corporate income tax rate. Since certain preferences are not allowed in calculating the corporate AMT, those preferences were essentially eliminated in the move (since the statutory rates are otherwise the same). That includes the effective elimination of the Research and Experimentation Tax Credit for large corporations, as well as the full or partial reversal of a number of the structural reforms to the international tax system—with the AMT apparently creating something close to a worldwide rather than a territorial tax regime.\(^{14}\) Some of these moves we might consider better than the alternative in the bills, but they were surely unintended—and seem likely to be reversed in conference. Nonetheless, they illustrate the significant pitfalls in trying to legislate so quickly. In this case, the basic structure of the corporate tax system turned out to be something fundamentally different than intended.

- **Taxable contributions to capital.** As Mike Schler has pointed out, the House bill provides that capital contributions to any entity are taxable to the entity, unless the contributor receives stock or other equity in the transaction. This rule overturns longstanding rules that capital contributions are generally not taxable to the receiving

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entity. The rule is broadly written, and could lead to a variety of unintended consequences with adverse effects on taxpayers and businesses.\footnote{These unintended results, and others, are described in Schler, note 1, at 22-26.} For example, this rule could result in taxable income whenever a non-pro rata contribution is made to an entity and equity is not issued in the exchange. This could easily arise in the case of contribution to a corporation by a large shareholder without a proportionate contribution by a minority shareholder, or a contribution by limited partners to a hedge fund or to a private equity fund, without a proportionate contribution by the general partner with respect to its profits interest. This rule could also create unintended taxable events when capitalizing different entities within a corporate structure. Finally, the rule could lead to uncertain application of the tax law when properties with built-in gains and losses are contributed to an entity in exchange for a partial or misvalued equity interest.

III. Conclusion

The analysis in the report reflects the collective efforts of members of the tax community over the preceding weeks to scrutinize the proposed changes, and to identify the areas that could create adverse and unintended consequences. Further problems with the bills are likely to emerge. These tax games will reduce tax revenues and thereby increase the true cost of the legislation and make the legislation more regressive than it now appears. Furthermore, additional tax complexity will be necessary in order to police the new rules and to prevent these abuses, ensuring that this legislation will move us further away from the goals a simpler, more equitable, and more efficient tax system. Finally, the IRS and Treasury may be overwhelmed in their efforts to police the new and manipulable rules during a period of reduced funding and budgetary constraints.

As described in the introduction, our immediate concern in this report is not the underlying policy motivations of the tax reform (though a number of us have separately expressed objections to these motives), but rather with the way that these goals are effectuated through the proposed statutory changes. The House and Senate versions of the bill were drafted through a rushed and closed process, without adequate regard for the intricacies of the tax law and the risk of unintended consequences. This report illustrates exactly why a transparent and deliberative process is crucial when introducing dramatic changes to the tax law.

Many of the problems that we identify do not have easy solutions. Tax planning is likely to arise whenever certain activities or taxpayers are granted favorable treatment, as taxpayers and their advisors restructure transactions to qualify for the favorable treatment. Effective rules are needed to prevent these abuses, but are in many cases inadequate under the proposed legislation.
We urge the members of the Senate and House to reassess the tax reform process and the resulting legislative proposals, and to undertake a more deliberative approach to far-reaching legislation that will significantly effect our economy and taxpayer behavior.
IV. Appendix

This Appendix provides greater detail on the tax games, roadblocks and glitches described above.

A. Using Corporations as Tax Shelters

Under current law, the top statutory tax rate is 39.6% for ordinary income and 20% for qualified dividends and long-term capital gains, before accounting for the Pease provision, employment and self-employment taxes, the additional Medicare tax on high earners, and the net investment income tax. The Pease provision potentially adds approximately 1.2 percentage points to a taxpayer’s marginal rate, while taxes on employment, self-employment, and net investment income add up to 3.8 percentage points. Thus, the top marginal rate is 44.6% for ordinary income and 25% for qualified dividends and capital gains.

The House and Senate bills both eliminate the Pease provision, and the Senate bill reduces the top statutory rate on ordinary income from 39.6% to 38.5%. Neither bill affects the statutory tax rate on qualified dividends and long-term capital gains or alters employment and self-employment taxes or the net investment income tax. Thus, the top marginal tax rate on ordinary income will be 43.4% under the House bill (39.6% + 3.8%) and 42.3% under the Senate bill (38.5% + 3.8%), while the top marginal rate on qualified dividends and long-term capital gains will be 23.8% under both bills. The corporate tax rate will be reduced from a top rate of 35% under current law to a flat 20% rate under the House and Senate legislation.

In the examples that follow, assume that a taxpayer in the highest bracket has $1,000 available for investment, and can earn an annual pretax return of 4% on this amount through a fixed-income investment for a ten-year period. Under a baseline case, if the taxpayer invested the money directly, the return would be taxed at the 43.4% rate, for an annual after-tax return of 2.26%. After ten years, the investment would grow to approximately $1,250.

• Stuffing the C-corp. In the simplest example, the taxpayer contributes the $1,000 to a corporation, and the investments returns accrue within the corporate solution. If the 4% annual return is taxed at the 20% corporate tax rate, the investment earns an after-tax rate of return of 3.2%. After ten years, the investment would grow to approximately $1,370. If this amount is distributed and the $370 of earnings are taxed at the 23.8% rate, the investor will be left with a total after-tax return of $1,282. Even with the double tax, the investor has earned a somewhat higher after-tax return by investing through a corporation.

16 This example is similar to the one presented by Schler, Schler, supra note 1, at 1-2.
Now consider the result if the taxpayer dies at the end of Year Ten, while the investment is still held by the corporation, and her heirs receive a stepped-up basis in the corporate shares. The heirs will take a basis in their shares equal to the fair market value of $1,370, and the entire $370 of income entirely escapes the individual level tax. The taxpayer earned almost a 10% premium by investing through the corporation.\(^\text{17}\)

Of course, a similar result is achieved under current law when a taxpayer holds any asset until death. The House and Senate versions of the tax bill, however, would dramatically expand the availability of this strategy. As illustrated above, a low corporate tax rate allows this strategy to be used to defer income from fixed-income investments, which would otherwise generate current income to the taxpayer and would not present any opportunities for deferral.

The same strategy may also be used to reduce the effective tax rate on investments in dividend-paying stocks, even though the dividends would otherwise be taxed at a preferential rate to the individual investor. This is because dividends paid to the corporation would benefit from the 50% (or greater) dividends received deduction, which would halve the tax rate paid by the corporation on dividends received to 10%.\(^\text{18}\)

- **Transforming labor income into corporate profits.** Now take a step back and consider how the taxpayer earned the money available for investment. Here, too, a low corporate tax rate can be used to shield a portion of labor income from tax. Assume, for example that the taxpayer earns $1,000 of labor income. If the income is taxed at the top ordinary rate, the individual will only have $566 available to invest (after income, employment, and additional Medicare taxes). At the annual 2.26% individual after-tax rate of return described above, the income will grow to only approximately $708.

If, however, the taxpayer's income is earned through a corporation, the same $1,000 of income will be taxed at a 20% rate, leaving $800 available for the corporation to invest.\(^\text{19}\) At the annual 3.2% corporate after-tax rate of return described above, the income will grow to approximately $1,096. If that income is subject to a second layer of tax of 23.8%, that leaves $835—an 18% after-tax premium by using a corporation. The savings are supercharged if there is no second layer of tax—through a step up in basis (or keeping the corporate stock in a Roth as described below or the partial exclusion for gains on certain small business stock). In this case, the $1,096 faces no additional individual-level tax, and the taxpayer earned a premium of approximately 55% by both sheltering their labor

\(^\text{17}\) \((1,370 - 1,250) / 1,250 = 9.5\%

\(^\text{18}\) This scenario is described by Daniel Hemel.

\(^\text{19}\) A taxpayer would not be able to shield all of their labor income in this manner, but would be able to shield any amount in excess of reasonable compensation paid by the corporation to the taxpayer.
income and investing the after-tax proceeds through the corporation. Moreover, a corporation could deduct state and local taxes that an individual could not.

- **Salaries in a closely held corporation.** The tax advantage in this scenario is generally the same as in the examples above. The only difference in this case is that a taxpayer who is both a shareholder and employee of a closely held corporation does not need to go through the additional step of incorporating to shield a portion of their labor income. If the taxpayer earns a $1,000 salary from the corporation, this income is taxed at the ordinary rate, leaving only $566 available to invest. If, however, the taxpayer foregoes a portion of her salary in exchange for greater retained earnings at the corporate level, this amount is effectively taxed at the lower corporate rate (in the form of higher net corporate income). The corporation may then invest the after-tax amount of $800, which will similarly accrue at the corporation's higher after-tax rate of investment return—and with the total amount of savings depending on whether the second layer of tax is avoided or not.

- **Gaming retirement (and other ways to avoid the second layer of tax).** Finally, a taxpayer planning for retirement can achieve a result similar to the basis-step up scenario, without actually having to hold the corporate interest for her entire life. If the taxpayer in the previous example holds the corporate shares in a Roth account, then upon retirement the taxpayer pays no additional tax upon receipt of a distribution from the corporation, or upon a sale of the corporate interest. For example, assume that the taxpayer retires at the end of the ten-year period, when the $800 after-tax corporate investment has grown to $1,096. In this case, the total $296 of income may be distributed to the taxpayer tax-free, and labor income previously taxed at the low corporate rate also avoids the double level of tax. In effect, the taxpayer was able to use a combination of the Roth rules and the low corporate tax rate to shield the labor income from tax, invest this higher after-tax return at the lower rate, and then finally receive the final distribution tax-free. This strategy allows the taxpayer to make a Roth investment from pre-individual-tax, rather than after-tax dollars, and also to circumvent the limits on contribution to Roth accounts.

A similar—though somewhat less favorable—result is accomplished outside the Roth context, if the taxpayer receives the distributions from the corporation after she is no longer working and has consequently moved into a lower bracket.

Finally, there are other ways to avoid the second layer of tax on the corporate stock and, as a result, super-charge the tax savings. For instance, IRC 1202 provides for an at least partial exclusion of gain on certain “small business stock,” again partially avoiding the second layer of tax.

Of course, as noted above in the main discussion, we do not suggest that taxpayers will be able to use these strategies without limit, and these transactions will be subject to judicial, statutory, and
regulatory anti-abuse rules. But many of these anti-abuse rules rely on IRS action, and these doctrines have been relatively ineffective in the past. Further, we expect that the resource-constrained IRS will face significant barriers to addressing all of these loopholes in the short term. We also expect that the proliferation of avoidance opportunities will lead to a further diversion of resources away from productive activity and towards tax planning.

More critically, these examples illustrate the general problem with reducing the corporate tax rate without making additional corollary changes to the structure of income tax, such as a transition to a system that taxes publicly traded corporations on a mark-to-market basis and others on a pass-through basis. A unilateral reduction in the corporate rate opens up new opportunities for tax planning, and is certain to result in additional and unanticipated revenue loss.

B. Pass-Through Eligibility Games

Both the Senate and House bills effectively provide lower tax rates to certain pass-through business income. The Senate does this by providing a 23% deduction for relevant income—essentially, lowering the top rate in the bill for applicable income from 38.5% to just under 30%. The House bill simply sets a 25% top rate on applicable income.

The two bills provide this benefit to certain pass-through business owners (but not to others) and not directly to employees. Here is some additional detail on the structures of these provisions:

- In both bills, certain activities face restrictions on availability of the preferential rate. Specifically, service providers in such fields as law and health cannot take advantage of the pass through rates in a number of circumstances—though the restrictions are gameable as described further below. In the House bill, there is a further limitation on any person who is actively involved in a trade or business (i.e. working at the firm), with the default being that only 30% of the person’s income from the activity is eligible for the special low rate. In the Senate bill, the ability to take advantage of the lower pass-through rate is limited on the basis of the firm’s W-2 wages. Specifically, the deduction is capped at 50% of the W-2 wages paid by the firm and allocable to the taxpayer. For example, if a firm has two equal-part owners and pays $1 million in wages, each owner’s allocable portion of wages is $500,000 and her maximum deduction is $250,000.

20 These may include judicial principles such as assignment of income and the economic substance doctrine, statutory provisions such as § 269A (personal services corporations), § 482 (allocation of income and deduction among taxpayers), § 531 (accumulated earnings tax), and § 542 (personal holding companies), and regulations that the IRS may promulgate pursuant to those provisions and the new tax legislation.

21 Schler, supra note 1, at 3.
• In the Senate bill, the restrictions on the types of services eligible for the new deduction and the limit on the deduction to 50% of employee wages do not apply to sole proprietors, partners, and S-corporation shareholders with taxable income less than $500,000 for a married couple or $250,000 for an individual.

• In the House bill, the limitations on active involvement in the business and on services from specific fields can be waived on the basis of capital investment in the firm. Income that is essentially deemed to come from that capital investment is eligible for the pass-through rate. If a taxpayer is not in a restricted service sector, she would only take advantage of this exception to the degree the deemed income exceeds 30% of the total income (since this amount is automatically subject to the pass-through rate). Those in restricted service sectors can take advantage of this exception to the degree this income from capital investment exceeds 10% of total income.

• Employees do not benefit from the special pass-through rate on any of the income that they earn from that employment. The benefit is reserved for “owners,” such as sole proprietors, partners, and S-corporation shareholders.

Based on these rules, certain groups seem to be clearly eligible for the preferential rate without much tax planning. For example, passive investors in firms receive the full benefit under both bills (assuming, under the Senate bill, the firm pays enough in employee wages).

However, other groups can plan their way into eligibility. And this planning could lead to much larger revenue loss than is now being assumed—especially if, under the Senate bill, the treatment of service providers in partnerships isn’t clarified.

• **How employees could recharacterize themselves as “ owners” under the Senate bill—and the legal ambiguity.** The Senate rules can be read to allow service providers in partnerships to get the benefit of the pass-through deduction—so long as they are not receiving a “guaranteed payment” and so long as they are acting in their capacity as partners. If that is true, employers and employees should restructure so that employees can benefit from the lower pass-through rate, and even in fields that are subject to certain restrictions. (This game would work under the Senate bill but not under the House bill, since the latter applies its restriction based on capital investment.)

This is the Law Firm Associates, LLC game described earlier. Yes, these associates provide services in law, but the restriction on activity only applies to those with income at or above $500,000 in taxable income for a married couple and $250,000 of taxable income for a single individual. Notably, many law firm associates make less than that. (And keep in mind, this is taxable income—after accounting for all deductions taken in

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22 Thanks to David Miller for this example. Mike Schler also discusses this in his forthcoming article.
translating gross into taxable income.) The associates couldn't be given a "guaranteed payment"—i.e. a guaranteed amount each year. Instead, compensation would have to depend in some way on the profits of Law Firm Associates LLC. But, associates shouldn't be too worried. The partners in the original firm can simply contract with Associates LLC to provide a steady stream of income.

Through this mechanism, firms—with sufficient sophistication and with employees with sufficiently high income that the tax savings are worth the trouble—can potentially transform employees into "owners" and thus make them eligible for the pass-through rate.23

The same may also be true of those who are characterized as "self-employed" sole proprietors (e.g. independent contractors) rather than employees. They too may be able to benefit from the pass through provision.

Importantly, this may not be the Senate's intent. Specifically, the Senate provision has a subsection governing "reasonable compensation" and "guaranteed payments." If these, along with payments to a partner not acting in her capacity as a partner, are received in exchange for services, they are not qualified income (i.e., not qualified for the pass-through deduction). Under current rules, it is easy in a partnership to avoid having a payment characterized as a guaranteed payment, and it is also easy to be found to be acting in the capacity of a partner (though Treasury could by regulation try to tighten that definition considerably). So, the key question under this Senate provision is whether a part of a partner's profit share received in exchange for services will be deemed "reasonable compensation" and thus not eligible for the pass-through deduction. And, for the self-employed, the question is whether their own business earnings would be subject to the same standard.

Past practice and part of the legislative history suggests the "reasonable compensation" standard would not apply at least to partnerships. Instead, this reasonable compensation standard has in the past only applied to corporations, requiring them to pay "reasonable compensation" to owners. By contrast, partnerships have been governed by the rules under IRC 707, requiring certain payments to be considered "guaranteed payments" and certain activities to be considered not acting in a capacity as a partner. But, those rules under IRC 707 would not—under current regulations—stop the kind of rearrangements we describe above from giving service providers the full benefit of the pass-through deduction. Further, the Joint Committee on Taxation's description of the Senate bill and

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23 This game—of becoming employees in a partnership—could also work for high income employees assuming their new "partnership" isn't providing a restricted service. However, you'd also have to give their new firm some employees to get them over the employee salary requirement—which applies to those over that $500,000/$250,000 threshold.)
the Senate Finance Committee’s section-by-section analysis both state that the pass-through deduction is not available to “any amount paid by an S corporation that is treated as reasonable compensation”; neither document addresses amounts paid by partnerships or through sole proprietorships. Arguably, the “reasonable compensation” standard could be applied more broadly—and, if this were true, this loophole would be largely closed—but this would likely require regulatory action by the IRS (with only weeks remaining before the new legislation is likely to take effect) and the IRS action could be subject to challenge in court.

If Congress does not intend for this massive loophole in the Senate’s pass-through provision, it must address this directly. It must make clear either in legislative history or, preferably, in the statute that partnership profit allocations would be recharacterized as wages and not eligible for the deduction to the degree they represent “reasonable compensation” for services—and it must make clear that the same is true of business earnings via a sole proprietorship. Congress cannot simply rely on the existing rules under IRC 707 if it wants to close this gap.

To be clear, the “reasonable compensation” standard is weak in itself. That too can be gamed and has been in the S-corporation context. It is surely better than nothing. A more comprehensive solution would require Congress or the IRS to promulgate much more detailed rules so that taxpayers can determine what portion of partnership income is reasonable compensation and what portion is eligible for the pass-through rate.

- **Under the House bill, go “passive” or add capital.** The House bill’s restriction depends on capital investment. The key difference is that passive owners benefit from the full rate reduction, but active participants do not.

Taxpayers therefore have an incentive to go passive if possible, or, if an active participant in a firm, to add capital in order to increase the benefit from the pass-through rate. As analysts like Dan Shaviro and Mike Schler have pointed out, the tax code’s definition of passive activity was never intended to give people a benefit. It was designed to actually restrict loss taking and so hasn’t faced pressure of people trying to fit in. This then leads to a number of the games already described above.

Under the House legislation, you can also make a capital investment and take part of the benefit of the lower pass-through rate that way—and this particular game deserves additional explanation. As noted above, doctors and lawyers should own their own building. The rules provide a way for the income attributable to the building to get the lower pass-through rate. But, if the building is valuable enough, they could shield income beyond that—income from lawyering. The reason is that the provision assumes a very high rate of return from the capital investments, far above market rate (it assumes the
short-term rate plus seven percentage points). That then allows the building to shield income from services that otherwise wouldn’t be eligible for the pass-through rate.

- **Avoiding the line of business restrictions**: or how to be a top paid law partner or sports player and still benefit from the lower rates. In the main text, we describe a number of games to play (with much thanks to Mike Schler for describing most of these)—such as setting up a separate company owning the brand. One issue deserves additional explanation here. Under the Senate bill, one barrier to a move like this—putting the brand name in a separate company to take advantage of the pass-through rate—is the restriction based on wages paid to employees. Specifically, the deduction cannot exceed 50% of the wages paid to the employees. However, even for extreme cases (like the famous sports player setting up a separate pass-through to manage the brand), there could be a workaround. The player may not have many employees, but he could have one. Himself. The pass-through could be an S-corporation, and it could pay “reasonable compensation” to him, as required under the law. That reasonable compensation represents wages, and, thus, using the S-corporation, he can pay himself just enough wages to get the pass-through rate on a large portion of his income.

As noted in the main text, the first best solution to these problems is to drop the pass-through preferences entirely, but a second best solution would involve taking the time to substantially strengthen the guardrails as described there.

### C. Restructuring State and Local Tax Deduction to Maintain Deductibility

Under both the House and Senate bills, the itemized deduction for state and local taxes for individuals is limited to $10,000 and only for property taxes. Non-income taxes\(^24\) that are accrued in carrying on a trade or business, however, remain deductible for individuals. As noted earlier, states are likely to respond by shifting toward deductible taxes without changing significantly who pays the taxes as an economic matter. The following deductible taxes could all be used in place of nondeductible individual income taxes:

- **Property taxes**: States can shift to greater use of the property tax.\(^25\) This will be easier in some states and localities than others. One common concern with the property tax is that it is not tied to “ability to pay,” and thus can impose high costs on liquidity constrained

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\(^{24}\) There is some language in the current bills that suggests that income taxes are specifically not deductible by individuals, even if accrued in carrying on a trade or business. However, there is a strong argument, based on traditional income tax principles and other parts of the code that remain in force, that income taxes accrued in carrying on a trade or business (like the NYC Unincorporated Business Income Tax) remain deductible to individuals as well, as an “above-the-line” deduction. In any event, if income taxes were not to be deductible for an individual carrying on a trade or business, this would simply provide incentive for an individual no longer to carry on a trade or business as an individual.

\(^{25}\) For further discussion, see Darien Shanske [here](#).
taxpayers. There is a traditional response to this problem, which is to create a “circuit breaker”—a check on how high a percentage of a taxpayer’s income can be used to pay property taxes. Circuit breakers are used in many states in one form or another. Many experts believe they should be used much more. The proposed changes to the SALT deduction would give states a significant incentive to utilize large and generous circuit breakers in order to encourage greater use of deductible property taxes. The circuit breaker could even be designed to kick in when property taxes paid exceed roughly the percent of income a taxpayer paid before the repeal of the SALT deduction. Most states have income taxes and so regularly collect all the information that they need to administer a large circuit breaker. Also, given that most tax returns—certainly itemized tax returns—are likely to be prepared by an expert and/or by means of automation, additional complexity, such as taking into account the percentage of property taxes paid before tax reform, ought to be achievable.

There would be coordination issues of course. For instance, local property taxes are collected at different times than state income taxes. Yet this problem is solvable given that state legislatures typically control the timing of the collection of both taxes. States and localities also regularly borrow in anticipation of tax revenue should such a structure create liquidity problems for a government.

This particular expedient is limited. It would only help itemizers who currently do not deduct $10,000 in property taxes, but do have other taxes to deduct. What this expedient would do is make certain that any itemizer with $10,000 or more in state and local property and income taxes will get to deduct at least $10,000, even if the property tax component is less than $10,000. The amount of revenue this would cost the federal government could be quite significant.

- **Employee payroll taxes.** Neither the House nor Senate bill eliminates the ability of businesses to deduct their taxes. This makes sense as these taxes are an ordinary and necessary business expense. Yet opening up a chasm between deductible business taxes and nondeductible individual taxes invites states to shift from one form of revenue collection to the other. Indeed, several states, particularly states without an income tax, have experimented with new business level taxes recently. As with property taxes, states need not engage in fundamental fiscal reform. Rather, states could seek to increase the deductibility of their taxes by means of increasing taxes whose incidence is expected to remain on the individual. For example, a state could reduce its personal income tax, but impose/increase a state payroll tax with legal incidence on the employer. Since the tax is levied on the employer, the employer would still be able to deduct the taxes—even as it would function, in economic terms, very similarly to an income tax imposed directly on the employee. The result would be a reduction in wages (to pay the tax), and that

26 For further discussion, see Daniel Hemel [here](#).
reduction in wages (basically, paying the tax) would essentially be deductible against federal income taxes—since it reduces AGI.

It is worth noting that state income taxes are often less progressive than federal income taxes and so the amount of substitution toward a flat rate payroll tax could be very large. Even a relatively progressive tax structure has rates at the bottom that could be wholly replaced by a payroll tax, and the system as a whole could maintain (or enhance) current progressivity by combining an increased payroll tax with refundable tax credits provided directly to workers through the individual income tax system.

Imposing such a payroll tax would be fairly straightforward for a state to administer, even for states without an income tax. This is because employers already have to pay payroll taxes on their employees’ wages to fund unemployment insurance. A system of refundable credits might be more complicated, but some states already have smaller credit systems (via state EITCs) in place.

Shifting to payroll taxes in this way, if a large enough trend, could wipe out all savings from repeal of the SALT deduction—and then some. This is because most taxpayers do not itemize, but this strategy, in effect, could make a sizable portion of all current state income taxes deductible.

- **Charitable gifts.** Neither the House nor Senate bill repeals the charitable deduction. Donations to state and local governments are generally deductible. Thus charitable donations offer another substitute for the state and local tax deduction.27 A $10,000 gift to one’s local school district reduces one’s federal taxes just as much as $10,000 in local property or income taxes. Once again, the question is how to transform the $10,000 that is currently raised in non-deductible taxes into $10,000 raised in deductible charitable donations. The answer, much as with the other examples, is for states with an individual income tax to offer a tax credit for charitable donations made to state and local governments or specific parts of state and local governments. There is substantial authority that the credit can be as high as 100%, while preserving the charitable deduction (and despite the apparent quid pro quo), because states do offer such credits for tuition at tax-exempt private schools. Given the changes that the Senate bill makes to 529 plans in connection with spending on private school tuition, it would be incongruous for these credit regimes to be upended. The repeal of the SALT deduction is therefore an invitation for many more states to offer these plans and to make them quite generous.

- **Business “franchise” taxes on pass-throughs.** As explained above, the current bills are designed to benefit taxpayers who earn income through pass-throughs and, in all likelihood, will provide benefits to such taxpayers far beyond what has been anticipated.

27 For further discussion, see Manoj Viswanathan here.
States can seek to recapture some of this benefit by imposing (or encouraging local governments to impose) business “franchise” taxes—taxes imposed on the business entity. Such taxes appear to remain deductible even if imposed on “pass-throughs” (and so ultimately deducted by the individual). That is because both bills would maintain the deduction for taxes accrued in carrying on a trade or business or investment—though potentially not income taxes accrued by individuals. As a result, most franchise taxes would seem to remain deductible. This is a sensible result to the extent that states have a legitimate interest in taxing business entities based on how profitable or valuable they are. Current versions of these taxes are sometimes based on the capital or net worth of the firm, or, in the case of NYC, the income of the firm. We could envision challenges to deducting some of these taxes (specifically those based explicitly on business income) in the pass-through context, but we are fairly certain that at least some forms of these taxes would remain deductible even if imposed on pass-throughs. Once a form of tax is shown to be successful, then we would expect it to be emulated.

As with the property tax, states could mitigate the possible burden of such business taxes on individual owners with modest or even higher incomes by linking these taxes up to their individual income tax systems—for instance, by reducing individual income tax liability based on franchise tax payments.

As we discussed in the main text, we do not think there are any straightforward fixes here. The various substitutes and expedients have long pedigrees and their own policy rationales. The key legal doctrines, such as the use of legal incidence, are crucial for the functioning of our tax system overall. Finally, the cost to the states of instituting these changes relative to the potential gains is small. As described in greater detail in the main text, the three options we see are: 1) reduce or eliminate the cutback; 2) use a realistic revenue estimate if the current cap is retained; or 3) broaden the scope of taxes that can be deducted and phase-in a higher cap.

D. International Games, Roadblocks, and Glitches

1. Problems with the Minimum Tax on Intangible Income

The Senate and House bills impose a minimum tax on intangible income (the GILTI regime in the Senate and the high profit foreign-subsidiary regime in the House). The tax base for the minimum tax is calculated by taking the income of the controlled foreign corporation and subtracting out a routine rate of return on the tax basis of the corporation’s tangible property.

The following points elaborate further on problems discussed above in the main text:
- **The minimum tax on intangible income can be avoided through leverage.** Firms can use leverage to create basis in tangible assets, wiping out their minimum tax liability on intangible income. Because borrowed funds increase basis in assets, a firm can use the leverage to shield the intangible income, engaging in a type of tax arbitrage since the interest expense will also be deductible.

- **The minimum tax formula induces companies to locate real assets offshore.** In addition to the incentives discussed in the main text, the minimum tax rate effectively encourages firms to locate manufacturing subsidiaries (and manufacturing jobs) in low-tax foreign countries (instead of the U.S.) and then having those subsidiaries sell their products back into the United States (and other market countries). Such sales would be subject to 10% taxation, whereas firms would face a 20% tax on U.S. sales if done through a U.S. manufacturer (and, under the Senate bill, a 12.5% rate on export subsidies through the FDII regime, which is discussed below).

- **The global approach to the minimum tax induces companies to locate investment offshore.** In both bills, the minimum tax is calculated on a global basis. This incentivizes firms to shift investment offshore in order to blend low- or zero-taxed income from tax havens with income from higher-tax foreign countries, thus avoiding the minimum tax altogether. For instance, say a corporation earns $100 of income in Country A, which is taxed locally at a 20% rate. Additional income of $100 in the United States would be taxed at the new corporate rate of 20%, for a total tax liability of $40 ($20 to Country A and $20 to the United States). If the income was instead earned in a tax haven, Country B, which taxes the income at a 0% rate, total foreign taxes imposed would be $20 (Country A taxes), 80% of which ($16) are creditable against the 10% minimum tax imposed by the United States. The 10% minimum tax thus produces a U.S. tax liability of $4 [(10% × $200) − 16], thus bringing down the total tax liability (both foreign and domestic) to $24 (as opposed to $40 if the additional investment was located in the United States).

Further discussion of the solutions described above in the main text:

- A partial solution would be to limit the ability to use leverage to create tangible asset basis that shields income from the minimum tax. Interest expense could be netted from the deemed rate of return, but this approach could preserve an arbitrage opportunity between the actual interest expense and the high 10% deemed rate of return. Conversely, the debt principal could reduce the tangible asset basis, but this could overly penalize

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28 The leveraging strategy comes from analysis done by Mike Schler and Mitchell Kane. Schler, supra note 1, at 44; Email from Mitchell Kane to David Kamin and Ari Glogower (Dec. 4, 2017).

29 Thanks to Cliff Fleming for this point. Also, this scenario is inspired by correspondence with Steve Shay.
non-abusive debt-financed businesses, and bring all debt-financed tangible assets into the
GILTI tax base.  
• Alternatively, one could ignore debt and instead exempt an amount equal to a risk-free
rate of return to the equity in each CFC. If one does not limit the ability to use leverage,
then at the very least the 10% deemed return on tangible asset basis could be set at a
lower percentage rate.
• More comprehensive solutions are discussed above in the main body.

2. Problems with the Reduced Rate on Foreign-Derived Intangible Income (FDII)

The Senate bill allows for a 37.5% deduction for foreign-derived intangible income (FDII), thus
effectively subjecting such income to a favored 12.5% rate. The way that it is calculated means
that the greater the U.S. taxpayer’s income from exports, the more of its income gets taxed at the
12.5% rate.

Further discussion of problems:

• The reduced rate on foreign derived intangible income can be gamed through resale
transactions. Goods sold for foreign use generate income, a portion of which gets the
12.5% FDII rate. Goods sold for domestic use do not get the favored rate. There is
currently no mechanism that differentiates goods sold for foreign use from goods sold for
domestic use. Without anti-abuse rules, taxpayers will structure transactions to sell goods
abroad and have them resold back into the United States in so-called “roundtripping”
transactions, thus taking advantage of the FDII rate. Domestic corporations could even
sell to technically independent foreign distributors who resell into the U.S. but then
impose advertising and marketing requirements and price restrictions upon those
distributors. This approach would give the domestic corporation substantial control
without violating the technical independence of the distributors. Although the bill
provides that the taxpayer has to establish to the satisfaction of the Treasury Secretary
that the goods are sold for use abroad, taxpayers will take the position that the intent for
an initial sale to a foreign business is sufficient (like in a VAT regime).

• The reduced rate on foreign derived intangible income likely violates WTO
obligations. The way FDII is calculated means that the greater the U.S. taxpayer’s
income from exports, the more of its income gets taxed at the 12.5% rate (instead of the
20% rate). As such, it is likely an illegal export subsidy in violation of our WTO
obligations (specifically, Articles 3.1(a) and 3.2 of the Agreement on Subsidies and
Countervailing Measures and Article III:4 of the GATT 1994).  
This threatens to revive
a three decades-long controversy over export subsidies that was thought to have been put

30 This analysis was provided by Mitchell Kane.
31 For further discussion, see Rebecca Kysar here.
to rest in 2004 with the repeal of the extraterritorial income regime. Although the United States may argue that intangible income lies outside the scope of the WTO agreements, in the bill, the intangible income is simply a deemed portion of the income from the sale of tangible goods. Exports of tangible goods are clearly covered by the agreements, and thus the FDII rate will almost certainly fall within their scope. Given its uncertain legal status, firms will not be able to rely upon the change and will continue to locate IP offshore.

- The reduced rate on foreign derived intangible income is available to firms that have zero manufacturing or employees in the united states and induces firms to sell to foreign manufacturers rather than domestic. Firms can obtain the lower FDII rate while having zero manufacturing or employees in the United States—buying goods from a foreign supplier for resale abroad is sufficient.32 Perversely, the FDII rate also incentivizes firms to sell to foreign manufacturers rather than domestic manufacturers. This is because a U.S. firm will be unable to obtain the FDII rate when it sells unfinished goods to an unrelated U.S. manufacturer (since this qualifies as a domestic sale) but will be able to obtain the FDII rate when it sells unfinished goods to a related or unrelated foreign manufacturer (since this qualifies as an export).

Further discussion of the solutions:

- As discussed in the main text, we recommend jettisoning the FDII regime. If it is retained, we recommend neutralizing the rates on FDII and GILTI to avoid taxing the export income more heavily than the foreign intangible income (an undesirable result given the aims of the reform to bring investment home). One possible justification for a lower GILTI rate is the reduction of foreign tax credits in that regime, but if there are no foreign taxes paid (e.g. in tax havens) then the lower GILTI rate is a windfall.


The bills impose additional tax liability on deductible payments from certain corporations to foreign related persons through two different mechanisms (Base-Erosion Anti-Abuse Tax (BEAT), in the Senate, and the excise tax, in the House).

Further discussion of problems:

- BEAT likely violates WTO obligations and presents tax treaty concerns. The Senate bill imposes BEAT on deductible payments from certain corporations to foreign related persons. BEAT does this by adding back certain related party payments and imposing additional tax liability on this expanded base, effectively ensuring that at least 10% tax is imposed on such income. The BEAT presents WTO problems, and will likely be

32 This observation is from Mike Schler. Schler, supra note 1, at 40-41.
characterized by our trading partners as a forbidden charge on importation (General Agreement on Tariffs and Trade II section 1(b)) or a discriminatory internal tax (General Agreement on Tariffs and Trade III section 2). Although strengthening inbound taxation is a worthy goal, the United States should anticipate WTO litigation.

Although the Senate bill appears to be designed to avoid explicit overrides of our bilateral tax treaty obligations by imposing the tax on the U.S. entity and by not denying deductions or imposing withholding tax (unlike the House’s counterpart, the excise tax), our treaty partners will likely still view BEAT as violating the nondiscrimination requirement in the treaties (Article 24).33

- The excise tax likely violates WTO obligations and tax treaty obligations. The House bill imposes a 20% excise tax on certain payments made by a U.S. corporation to its foreign affiliates. The recipient may elect out of the excise tax by treating such payments as effectively connected with a U.S. trade or business. If such election is made, the House bill then applies the 20% corporate rate to a deemed measure of net income on such related party payments. Like its Senate counterpart (BEAT), the excise tax also presents WTO concerns as a forbidden charge on importation or a discriminatory internal tax.

Because of its mechanics, the excise tax also likely abrogates our bilateral tax treaties by effectively imposing a withholding tax on royalties (Article 9) and by undermining the treaties’ arms’ length principle (Article 12), permanent establishment (Article 7), and nondiscrimination (Article 24) requirements.

Clarification for business taxpayers: Payments under state or local tax credit programs may be deductible as business expenses

IR-2018-178, Sept. 5, 2018

WASHINGTON — Business taxpayers who make business-related payments to charities or government entities for which the taxpayers receive state or local tax credits can generally deduct the payments as business expenses, the Internal Revenue Service said today.

Responding to taxpayer inquiries, the IRS clarified that this general deductibility rule is unaffected by the recent notice of proposed rulemaking concerning the availability of a charitable contribution deduction for contributions pursuant to such programs. The business expense deduction is available to any business taxpayer, regardless of whether it is doing business as a sole proprietor, partnership or corporation, as long as the payment qualifies as an ordinary and necessary business expense. Therefore, businesses generally can still deduct business-related payments in full as a business expense on their federal income tax return.

Updates on the implementation of the Tax Cuts and Jobs Act (TCJA) can be found on the Tax Reform page of IRS.gov.

Related Items:

- State and Local Income Tax FAQs

Page Last Reviewed or Updated: 05-Sep-2018
EXHIBIT F
Treasury Secretary Mnuchin Statement on Clarification for Business Taxpayers: Contributions Under State and Local Tax Credit Programs Generally Deductible as Business Expenses

September 5, 2018

Washington—Today, the IRS clarified that business taxpayers who make business-related contributions to charities or government entities for which they receive state and local tax credits can generally deduct them as business expenses. The U.S. Treasury Secretary Steven T. Mnuchin released the following statement:

"The IRS clarification makes clear that the longstanding rule allowing businesses to deduct payments to charities as business expenses remains unchanged under the Tax Cuts and Jobs Act. The recent proposed rule concerning the cap on state and local tax deductions has no impact on federal tax benefits for business-related donations to school choice programs."

Please find additional information on this clarification here.

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October 10, 2018

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EXHIBIT G
Does the proposed regulation governing contributions in exchange for state and local tax credits affect the ability of a business that makes a payment under such a program to deduct the payment as an ordinary and necessary business expense?

No, the proposed regulation addresses the deductibility of such payments as charitable contributions under § 170. It does not affect the availability of a business expense deduction under § 162. A business taxpayer making a payment to a charitable or government entity described in § 170(c) is generally permitted to deduct the entire payment as an ordinary and necessary business expense under § 162 if the payment is made with a business purpose. The rules permitting an ordinary and necessary business expense deduction under § 162 apply to a taxpayer engaged in carrying on a trade or business regardless of the form of the business.

Updates on the implementation of the Tax Cuts and Jobs Act can be found on the Tax Reform page of IRS.gov.

Disclaimer

These FAQs are not included in the Internal Revenue Bulletin, and therefore may not be relied upon as legal authority. This means that the information cannot be used to support a legal argument in a court case.

Page Last Reviewed or Updated: 02-Oct-2018