AMERICANS for TAX REFORM

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Re: Contributions in Exchange for State or Local Tax Credits (REG-112176-18)

October 10, 2018

The Honorable Steven Mnuchin
Secretary
U.S. Treasury Department
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable Charles Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Dear Secretary Mnuchin & Commissioner Rettig:

I write regarding the proposed IRS rule limiting the ability of taxpayers to deduct charitable contributions made to state-based education scholarship funds.

While there is a legitimate need to design rules that prevent workarounds to the limitation on the state and local tax deduction and prevent a windfall for taxpayers that take the charitable deduction, ATR has concerns that the proposed rule unnecessarily harms legitimate charitable contributions to state-based education scholarship funds.

Limiting the ability of taxpayers to claim the charitable contribution when they donate to a state-based scholarship education fund disregards Congressional intent preserving the charitable deduction and represents a tax increase on individuals and businesses that contribute to a state-based education fund.

Ideally, the IRS rule should allow the federal charitable contribution in cases where the state credit does not fully reimburse the taxpayer.

Background

The Tax Cuts and Jobs Act (TCJA) repealed or limited numerous deductions and credits, including capping the ability of individuals to deduct state and local taxes (SALT) from their federal income taxes at $10,000. This is the right approach – ideal tax reform should move the code toward a system of lower rates for all and fewer distortionary credits and deductions.

In an effort to avoid the SALT limitation, several high-tax states have proposed allowing local municipalities to set up a charitable fund linked to a state level tax credit. The proposed IRS rule (REG-112176-18) addresses this gaming by preventing taxpayers from receiving the charitable deduction when that taxpayer contributes to a state-based charitable fund and receives a state level tax credit.

While the IRS is right to propose a rule that prevents abuse of the charitable deduction and stops taxpayers from receiving a windfall, the rule should ensure that legitimate charitable donations to state education programs are protected so that donors are not discouraged from contributing to state education funds and they are properly compensated after donating.

The Proposed Rule May Harm Charitable Contributions to State-based Education Funds

State-based scholarship programs are a key tool toward promoting school choice. School choice provides families, including low income households and children with exceptional needs, with the means and choice to give their children the education that best fits their needs.

Currently, 18 states have tax credit scholarship programs that provide almost 300,000 students with access to private education of their choice. These programs are backed by a state level tax credit that compensate a taxpayer between 50 percent and 100 percent of the amount donated.

Any final rule should ensure that taxpayers that contribute to existing state-based education scholarship program are not unduly punished by the tax code.

While the proposed rule allows a de minimis exception that exempts any state level credit that does not exceed 15 percent of a charitable contribution from the federal limitation, this is insufficient for states that have a tax credit below 100 percent and could harm taxpayers that contribute to charitable funds.

This could be particularly harmful for taxpayers that itemize their deductions but have not yet hit the SALT cap. Under the rule, these donors would see an increase in the cost of contributing to state based education funds.

To be clear, there is a legitimate need to curb practices that may allow a taxpayer to make money from the tax code by donating to a charity. Under some circumstances, a taxpayer could recoup 100 percent of their charitable contribution through the 100 percent state level tax credit and then receive a windfall through the federal charitable contribution.

At the same time, it is important to note that many states do not have a 100 percent credit. Of the 18 states with an education scholarship program, 11 provide a tax credit below 100 percent.

At the very least, these programs should be protected to ensure that taxpayers contributing to these state funds do not lose out from contributing to an education fund by being denied the federal charitable contribution.

The ideal solution would be to permit a taxpayer to deduct any contribution that is not reimbursed from the state level tax credit. For example, a taxpayer that makes a contribution of $1,000 and receives a 75 percent state level tax credit should be allowed to deduct the remaining 25 percent of the contribution as a federal level, charitable deduction.

<u>The Proposed Rule Disregards Congressional Intent</u>
While lawmakers chose to limit the State and Local tax deduction, they proactively retained the ability of taxpayers to deduct charitable contributions. In fact, the House bill, Senate bill, and conference report of TCJA all made no changes to the charitable deduction.

Limiting the charitable contribution through an IRS rule therefore runs counter to the intent of lawmakers.

Similarly, the ability of corporations to contribute to state-based education scholarship programs should be retained. The case against restricting corporate charitable contributions is even stronger. Not only did TCJA proactively retained the ability of corporations to deduct charitable contributions, TCJA also retained the ability of corporations to deduct state and local taxes.

As such, there is no justification for limiting the ability of corporations from donating to state funds.

Conclusion

The proposed IRS rule aims to stop blue states from avoiding the SALT limitation by gaming the charitable deduction and prevent taxpayers from receiving a windfall from charitable contributions because of generous state tax credits.

While these goals both represent good policy, any final rule should protect legitimate state-based education funds from tax increases that disincentivize charitable contributions. The final rule should ensure taxpayers remain fully compensated by the state and federal codes while avoiding any windfall that distorts decision making and allows taxpayers to game the system.

Thank you for your consideration. If you have any questions, please do not hesitate to contact me or ATR's Director of Tax Policy at ahendrie@atr.org or at 202-785-0266.

Onward,

Grover G. Norquist
President, Americans for Tax Reform