The Proposed SALT Regulations May Be Doomed

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I. INTRODUCTION

After much anticipation, the Internal Revenue Service finally issued proposed regulations on some blue states' efforts to avoid the new Section 164 state and local tax deduction limit (the SALT deduction limit)[1] through a "government charity strategy."[2] In short, that strategy contemplates that taxpayers will make nominal donations to government charities and receive substantial state tax credits in return.[3] Those tax credits will then be used to offset the taxpayer's tax liability.[4] The nominal donations, the states believe, will be fully deductible as charitable contributions under Section 170(a).[5]

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1. *See* I.R.C. § 164 (2017). Section references in this Essay are to the Internal Revenue Code of 1986, codified as amended at 26 U.S.C. (2017). Section 164 generally provides a $10,000 limit on an individual's deduction for state and local taxes. *Id.* § 164(b)(6)(B). The statute contains a few exceptions that are not relevant to most taxpayers. *Id.*

2. Contributions in Exchange for State or Local Tax Credits, 83 Fed. Reg. 43,563 (proposed Aug. 27, 2018) (to be codified at 26 C.F.R. pt. 1).

3. *See id.* at 43,564–65. As the term is used here, a government charity refers to any fund or entity that qualifies as an "integral part" of a government described in Section 170(c)(1), or to that government itself. *See* Treas. Reg. § 301.7701-1(a)(3) (2011); I.R.C. § 170(c)(1).

4. *See* Contributions in Exchange for State or Local Tax Credits, 83 Fed. Reg. at 43,564.

5. *See, e.g.*, Frank Sammartino, *How New York State Responded to the SALT Deduction Limit*, TAX POL'Y CTR.: TAXVOX BLOG (May 14, 2018), https://www.taxpolicycenter.org/taxvox/how-new-york-state-responded-salt-deduction-limit ("Here is how New York legislators believe the

Thus, taxpayers can easily avoid the SALT deduction limit. Nondeductible taxes will have been replaced with deductible charitable contributions.

But the proposed SALT regulations say that no Section 170(a) deductions will be allowed for payments that give rise to state tax credits.[6] Though the IRS did not need to issue these regulations—the government charity strategy fails under existing law—the regulations may discourage potentially lengthy court battles.[7] Thus, the IRS was wise to respond here.

Unfortunately, the proposed regulations suffer from some problems. Though the regulations properly treat nominal donations under the government charity strategy as payments made in exchange for state tax credits,[8] they do not further identify the consequences associated with that exchange. Most significantly, the regulations do not specify the taxpayer's basis in the acquired credits, nor do they specify the tax consequences associated with their later use.[9] This gap in the regulations, if left unaddressed, will confuse taxpayers and cause administrative problems for the IRS.

The regulations also run into problems when addressing the "private charity strategy."[10] That strategy, popularly associated with red states, involves creditable donations to non-government entities, such as private schools.[11] Although the IRS can properly deny tax benefits claimed under the private charity strategy,[12] the regulations do so in a conceptually incoherent way. They treat a creditable payment to a private charity in the same way as a payment under the government charity strategy (i.e., as a payment made in exchange for tax credits).

But this does not make sense. When a taxpayer makes a creditable payment to a private charity, the state, and not the charity, provides a tax

programs would work in the case of the new charitable funds: Itemizers who make the charitable gifts could deduct the full amount of their contributions on their federal income return . . . .").

6. *See* Prop. Treas. Reg. 1.170A-1(h)(3)(i), 83 Fed. Reg. 43,563, 43,571 (Aug. 27, 2018).

7. For a discussion of the problems with the government charity strategy under existing law, see generally Amandeep S. Grewal, *The Charitable Contribution Strategy: An Ineffective SALT Substitute*, 38 VA. TAX REV. (forthcoming 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3216189.

8. *See* Prop. Treas. Reg. 1.170A-1(h)(3)(i), 83 Fed. Reg. at 43,571.

9. *See id.* The IRS has solicited comments on the basis issue. *See id.* at 43,570 (requesting comments on the "determination of the basis of a transferable tax credit that a taxpayer sells or exchanges"). However, no comments were specifically requested on the tax consequences associated with the later use of an acquired state tax credit. *See id.*

10. As used here, a "private charity" refers to any fund or entity that is described in I.R.C. § 170(c), but which is not described in I.R.C. § 170(c)(1).

11. *See* CARL DAVIS, INST. ON TAXATION & ECON. POLICY, SALT/CHARITABLE WORKAROUND CREDITS REQUIRE A BROAD FIX, NOT A NARROW ONE: NARROW ACTION WOULD BE UNFAIR, ARBITRARY, AND INEFFECTIVE 3 (2018), https://itep.org/wp-content/uploads/charitableworkaround_0518.pdf (arguing that "[w]hile blue-state efforts to circumvent the SALT cap have attracted more attention," programs "in deep-red Alabama and elsewhere" involving private school tax credits present similar policy concerns).

12. *See* Grewal, *supra* note 7, at 23–32 (discussing potential regulatory options).

credit to the taxpayer. Thus, there has been no exchange transaction. The IRS should address the private credit strategy through a different approach. If it does not, a court should invalidate the final SALT regulations, either in whole or in part.

The remainder of this Essay fleshes out these points and offers some recommendations for improvement.

II. OVERVIEW OF THE PROPOSED REGULATIONS

To address the government charity and private charity strategies, the IRS has proposed relatively short regulations. Their key provision states that if a taxpayer makes a payment to any entity described in Section 170(c), the taxpayer's otherwise available charitable contribution deduction will be reduced for "any state tax or local tax credit that the taxpayer receives or expects to receive in consideration of the taxpayer's payment."[13]

This general rule plainly applies to the government charity strategy. Section 170(c) includes, among several others, states and their political subdivisions.[14] And, by design, taxpayers under the government charity receive state tax credits in exchange for their payments.[15] So, under the regulation, if a taxpayer pays $100 to a government charity and receives $100 in state tax credits, no charitable contribution deduction will arise. The attempt to convert nondeductible state tax payments into deductible charitable contributions will have been defeated.

Absent a special rule, the private charity strategy would not be caught by the regulations. Although Section 170(c) reaches private charities,[16] the regulation limits deductions for payments to them only when a taxpayer receives a state tax credit "in consideration for" her payment.[17] And when a taxpayer transfers money to a private charity and the state independently grants the taxpayer a credit, the taxpayer has not received that state tax credit

13. *See* Prop. Treas. Reg. 1.170A-1(h)(3)(i), 83 Fed. Reg. at 43,563, 43,571. The regulation applies to property transfers as well as cash payments. *See id.*; Prop. Treas. Reg. § 1.170A-1(h)(3)(vii), ex.1., 83 Fed. Reg. at 43,563, 43,571.

14. *See* I.R.C. § 170(c)(1) (2012) (stating that charitable contributions include contributions or gifts to "[a] State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes").

15. *See* I.R.S. Notice 2018-53, 2018-24 I.R.B. 750, 750 (June 11, 2018) (describing programs under which state legislatures "allow taxpayers to make transfers to funds controlled by state or local governments, or other transferees specified by the state, in exchange for credits against the state or local taxes that the taxpayer is required to pay").

16. *See* I.R.C. § 170(c)(2)–(5) (describing corporations and other entities that meet prescribed criteria).

17. Prop. Treas. Reg. § 1.170A-1(h)(3)(i), 83 Fed. Reg. at 43,571.

as consideration.[18] The private charity accepts the taxpayer's payment and provides nothing in return.

But the proposed regulations, in a rather awkward way, limit the taxpayer's Section 170(a) deduction under the private charity strategy. Through a special rule, "consideration" does not enjoy its usual meaning. The proposed regulations state that a taxpayer may have received a state tax credit in consideration for her payment even if that credit was not "provided by the donee organization."[19]

The regulations also provide a *de minimis* rule: If the state tax credit received by the taxpayer in exchange for her payment does not exceed 15% of that payment, she need not reduce her otherwise allowable Section 170(a) deduction.[20] This provision follows from the regulations' approach to state tax deductions.[21] That is, under the regulations, a dollar-for-dollar state tax deduction will not reduce the taxpayer's charitable contribution deduction, and a 15% credit, which may offer a roughly similar tax benefit, will be similarly ignored.[22]

The regulations, if finalized, will apply to creditable payments made after August 27, 2018.[23] However, the IRS believes that these regulations follow from "longstanding principles," and that they "clarify" how the quid pro quo doctrine applies to charitable contribution deductions.[24] This suggests that the IRS would deny Section 170(a) deductions for creditable payments made even before that date.[25] If that is so, the IRS should make its intent clear.

III. GAPS AND CONCEPTUAL PROBLEMS

Policy concerns easily support the proposed SALT regulations. As the IRS noted, Section 170(a) properly applies to "taxpayers' gratuitous payments to qualifying entities, not for transfers that result in economic returns."[26] Also, if the IRS ignored the problems with the government charity strategy, taxpayers could claim billions in improper deductions.

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18. Consideration usually refers to "[s]omething . . . bargained for and received by a promisor from a promisee." *Consideration*, BLACK'S LAW DICTIONARY (10th ed. 2014).

19. Contributions in Exchange for State or Local Tax Credits, 83 Fed. Reg. 43,563, 43,571 (proposed Aug. 27, 2018) (to be codified at 26 C.F.R. pt. 1).

20. *Id.*

21. *Id.* at 43,565 ("The de minimis exception reflects that the combined value of a state and local tax deduction, that is the combined top marginal state and local tax rate, currently does not exceed 15 percent.").

22. *See id.* at 43,571.

23. *Id.*

24. *Id.* at 43,565.

25. *See id.*

26. *Id.*

The private charity strategy does not raise the same threats to the fisc because states usually limit the credits available under that strategy.[27] A state may be indifferent between payments to its revenue department and payments to its own charity, but offering tax credits for payments to private charities carries budget consequences. So, there are natural limits to the private charity strategy.[28] But that hardly means that that strategy should create unwarranted tax benefits.[29] The IRS can thus properly deny tax benefits under the private charity strategy, if its denial is consistent with its statutory authority.

The IRS has addressed important problems through the proposed SALT regulations. However, the regulations contain a major gap because they do not address the consequences associated with the state tax credits deemed acquired under them. Also, the regulations' approach towards the private charity strategy suffers from severe conceptual problems. The next two sections explain these issues.

A. *ACQUIRED STATE TAX CREDITS*

Under the proposed regulations, a creditable payment to a Section 170(c) organization will be treated as made in consideration for state tax credits.[30] This naturally implies that the taxpayer will have purchased those credits, and that she should enjoy a Section 1012 cost basis in them.[31] When the taxpayer later uses those credits to satisfy her tax liability, she should enjoy a Section 164 deduction, subject to statutory limits. If her basis in her state tax credits differs from the tax liability satisfied through those credits, gain or

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27. *See generally* Joseph Bankman et al., *State Response to Federal Tax Reform: Charitable Tax Credits*, 87 ST. TAX NOTES 557 app. (2018) (summarizing various state tax credit programs and describing relevant limits).

28. At least one state government apparently welcomes thinner government coffers. *See* Howard Fischer, *In Arizona, Tuition Tax Credit Cap Faces Party-Line Stalemate*, ARIZ. DAILY SUN (Mar. 1, 2018), https://azdailysun.com/news/local/in-arizona-tuition-tax-credit-cap-faces-party-line-stalemate/article_06c98ce8-de1f-562e-8433-69d828fefad1.html (discussing problems with ever-increasing credit caps).

29. Historically, the principal federal tax benefits under the private credit strategy related to the alternative minimum tax. *See* Phillip Blackman & Kirk J. Stark, *Capturing Federal Dollars with State Charitable Tax Credits*, 139 TAX NOTES 53, 54 (Apr. 1, 2013).

30. Prop. Treas. Reg. § 1.170A-1(h)(3)(i), 83 Fed. Reg. 43,563, 43,571 (Aug. 27, 2018).

31. *See* Treas. Reg. § 1.1012-1(a) (2011) ("In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property."); Treas. Reg. § 1.263(a)–(4)(c)(1) ("A taxpayer must capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transaction.").

loss should arise.[32] Gain or loss should also arise if the amount realized on the sale of transferable state tax credits differs from their basis.[33]

Unfortunately, the proposed SALT regulations do not spell out any of these consequences. They simply acknowledge that a taxpayer has acquired state tax credits in consideration for her payment. Taxpayers may thus believe that the IRS will not allow them any otherwise available deductions when they later use their credits.

Taxpayers may be especially concerned about this issue because the IRS often denies that state tax credits may establish Section 164 deductions. The IRS usually argues that both the grant and the use of a state tax credit will be ignored for income tax purposes.[34] And the IRS might not want to upset its settled litigation position here.[35]

However, the proposed SALT regulations already upset that position because they do not ignore the grant of a state tax credit. The regulations plainly require that a taxpayer reduce her Section 170(c) deduction for state tax credits received.[36] Whatever logic supports ignoring both the grant and use of a state tax credit cannot support observing the grant of a credit but ignoring its use.

Strictly speaking, the proposed regulations do not deny that the later use of a state tax credit establishes Section 164 deductions. Rather, the regulations remain silent on that issue. And that silence could be forgiven if taxpayers could easily infer the subsequent tax consequences associated with

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32. For an internal IRS memo following this approach to purchased state tax credits, see I.R.S. Chief Couns. Mem. 201147024 at 7 (Nov. 25, 2011) (explaining that when a "purchaser applies the [purchased] tax credit to satisfy its state tax liability, the purchaser will realize gain or loss under § 1001 equal to the difference, if any, between the basis of the tax credit and the amount of liability satisfied by the application of the tax credit. In addition, the purchaser will be treated as having made a payment of state tax for purposes of § 164(a)."); s*ee also* Rev. Rul. 86-117, 1986-2 C.B. 157 (illustrating how a taxpayer recognized gain when paying state inheritance tax liability with property whose fair market value exceeded its basis); Alan L. Feld, *Federal Taxation of State Tax Credits* 151 TAX NOTES 1243, 1247 (May 30, 2016) ("For the purchaser of the state tax credit, the credit should qualify as a property right. Its adjusted basis equals the purchase price. When the purchaser applies the credit to satisfy state tax liability, a transfer of the property occurs, constituting a realization event.").

33. *See* Tempel v. Comm'r, 136 T.C. 341, 355 (2011), *aff'd sub nom.* Esgar Corp. v. Comm'r, 744 F.3d 648 (10th Cir. 2014) (characterizing gain on a disposition of state tax credits).

34. *See, e.g.*, Snyder v. Comm'r, 55 T.C.M. (CCH) 1334 (1988), *vacated and remanded*, No. 89-1276, 1990 WL 6953 (6th Cir. Feb. 1, 1990); s*ee also* Contributions in Exchange for State or Local Tax Credits, 83 Fed. Reg. 43,563, 43,564 (proposed Aug. 27, 2018) (to be codified at 26 C.F.R. pt. 1) (explaining that the "IRS Chief Counsel has taken the position in the U.S. Tax Court that the amount of a state or local tax credit that reduces a tax liability is not an accession to wealth under section 61 or an amount realized for purposes of section 1001").

35. *Cf.* Sunoco, Inc. v. United States, 129 Fed. Cl. 322, 324 (2016) (accepting the government's argument that federal tax credits used by the taxpayer should be treated as a reduction of the taxpayer's tax liability, rather than as a payment of tax); Exxon Mobil Corp. v. United States, No. 3:16-CV-2921-N, 2018 WL 4178776, at *1 (N.D. Tex. Aug. 8, 2018) (accepting the same argument).

36. *See* Prop. Treas. Reg. § 1.170A-1(h)(3)(i), 83 Fed. Reg. 43,563, 43,571 (Aug. 27, 2018).

acquired state tax credits. But they cannot. The regulations implicitly separate acquired state tax credits into three different categories, and the consequences for only the first category remain straightforward. That first category includes state tax credits acquired under the government charity strategy. For those credits, the consequences described at the beginning of this section should apply. Taxpayers have, under general tax principles, acquired those credits by purchase.[37]

The consequences for state tax credits received through the private charity strategy (the second category) are unclear. Although, for purposes of computing the Section 170(a) deduction, the proposed regulations deem those credits to have been acquired through an exchange,[38] that is not what has really happened. The state, not the recipient private charity, provides the taxpayer with the credits. Thus, the taxpayer cannot acquire a Section 1012 cost basis in them.[39]

But, under a sensible approach, a taxpayer should receive a basis in her state tax credits equal to their face value.[40] When a taxpayer includes income on the receipt of property, she usually will have a basis in that property equal to the amount so included.[41] Under a similar principle, when a taxpayer must reduce a deduction for the value of property received, she should acquire a basis in that property equal to the reduction.[42]

The final regulations should expressly provide this result. Otherwise, a taxpayer may recognize income when she later uses her state tax credit. Under Section 1001(b), her amount realized will equal the tax liability against which those credits were applied. But there would be no adjusted basis to offset that amount and income would arise.[43] And if the taxpayer has already reached the SALT deduction limit, she cannot offset that income with a Section 164 deduction. Income recognition problems may also arise if the taxpayer receives transferable state tax credits and later sells those credits.

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37. *See* I.R.S. Chief Couns. Mem., *supra* note 32, at 7; Feld, *supra* note 32, at 1247.

38. Prop. Treas. Reg. § 1.170A-1(h)(3)(i) & (iii), 83 Fed. Reg. at 43,571.

39. *See* Tempel v. Comm'r, 136 T.C. 341, 355 (2011), *aff'd sub nom.* Esgar Corp. v. Comm'r, 744 F.3d 648 (10th Cir. 2014); *see also* Solitron Devices, Inc. v. Comm'r, 80 T.C. 1, 17 (1983), *aff'd sub nom.* Solitron Devices v. Comm'r, No: 83-5253, 744 F.2d 95 (Table) (11th Cir. Sept. 5, 1984) (rejecting "the unusual concept that cost basis can be allocated to property other than the property purchased").

40. Under the proposed regulations, state tax credits reduce the otherwise available Section 170(a) deduction by their face value (that is, by the "maximum credit allowable"). *See* Prop. Treas. Reg. § 1.170A-1(h)(3)(iv), 83 Fed. Reg. at 43,571.

41. *See, e.g.*, Treas. Reg. § 1.61-2(d)(2)(i) (2003) (explaining that when property transfer gives rise to compensation income, the taxpayer's basis in that property will generally be the amount included in income).

42. This analysis assumes, for the sake of discussion, that applying the quid pro quo approach to the private credit strategy comes within the IRS's statutory authority. However, as explained in Section III.B, it does not. The IRS should abandon the quid pro quo approach and address the private credit strategy through a gross income approach.

43. *See* I.R.C. § 1001(a) (2012).

The third category of state tax credits addressed in the proposed regulations are those that are otherwise ignored under the *de minimis* rule. When a taxpayer makes a payment to a Section 170(c) organization and any resulting tax credit does not exceed 15% of that payment, the taxpayer need not reduce her Section 170(a) deduction.[44] To preserve this benefit, state tax credits ignored under the *de minimis* rule should enjoy a basis equal to their face value.[45] Otherwise, taxpayers may again recognize income when they use or transfer those credits.

The IRS might hesitate to issue regulations on how state tax credits intersect with Sections 164 and 1001, given the novel issues raised. However, it cannot claim that these issues were unforeseeable. In litigation, the IRS has successfully argued that the constructive receipt of refundable state tax credits gives rise to income.[46] And because those credits give rise to income, they must have an adjusted basis that will be taken into account in later transactions.

It is thus time for the IRS to explain the tax consequences for transactions involving the use of state tax credits. If doing so creates tensions with the agency's litigating position, it should change that position. The IRS should not withhold guidance to preserve a litigation advantage.

B. Private Charities

Some of the compliance problems created by the proposed SALT regulations stem from a conceptual flaw. The regulations err when they treat a taxpayer's payment under the private charity strategy as having been made in exchange for state tax credits. Those credits, after all, come from the state government, not the recipient private charity. There has thus been no exchange. If the final SALT regulations maintain this position, a court should wholly or partially invalidate them.

In the regulatory preamble, the IRS claims that the quid pro quo doctrine supports reducing the Section 170(a) deduction for any state tax credits received.[47] That argument makes perfect sense for the government charity strategy because the recipient there provides the taxpayer with a tax credit in

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44. *See* Prop. Treas. Reg. § 1.170A-1(h)(3)(vi), 83 Fed. Reg. at 43,571.

45. This writer believes that a 15% credit is far too substantial to qualify as *de minimis*. If the IRS properly applied substance over form principles, no state tax credit should be ignored under the government charity strategy. Rather, all state tax credits that arise through that strategy should be deemed to have been acquired through purchase. *See generally* Grewal, *supra* note 7 (providing further discussion of the current problems with the government charity strategy). But if the final regulations retain the *de minimis* rule for some state tax credits, those credits should be assigned a basis equal to their face value.

46. *See* Maines v. Comm'r, 144 T.C. 123, 132 (2015).

47. Contributions in Exchange for State or Local Tax Credits, 83 Fed. Reg. 43,563–65 (proposed Aug. 27, 2018) (to be codified at 26 C.F.R. pt. 1).

exchange for his payment. But there is no quid pro quo under the private charity strategy. The recipient provides no consideration to the taxpayer.[48]

The Supreme Court has confirmed this common-sense approach. In *United States v. American Bar Endowment,* the Court acknowledged that for a transfer to qualify for the Section 170(a) deduction, the taxpayer must have donative intent.[49] That intent will be shown when the taxpayer makes a transfer that exceeds the amount he expects to receive in return.[50] And if he exhibits that intent, an objective quid pro quo test applies. His transfer will qualify as a charitable contribution only if it has been made without receiving "a substantial benefit in return,"[51] that is, "without adequate consideration."[52] These references to amounts received in return and as consideration naturally imply that the Section 170(a) deduction should be reduced by only those amounts transferred by the recipient organization to the taxpayer. In other words, state tax credits that arise from a transfer to a private charity do not qualify as a quid pro quo.

The IRS has expressly codified these principles.[53] Under the current Section 170 regulations, no charitable contribution deduction will be allowed for payments made "in consideration for . . . goods or services."[54] The regulations further specify that this rule applies when "the taxpayer receives or expects to receive goods or services in exchange for [his] payment."[55] When the donee organization has provided such goods or services, the otherwise deductible amount must be reduced by "[t]he fair market value of the goods or services the organization provide[d] in return."[56] The

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48. *See supra* note 18 and accompanying text.

49. *See* United States v. Am. Bar Endowment, 477 U.S. 105, 117 (1986).

50. *See id.* at 118 (taxpayer must show "that he purposely contributed money or property in excess of the value of any benefit he received in return").

51. *Id.* at 116.

52. *Id.* at 118.

53. *See* Treas. Reg. § 1.170A-1(h)(1) (2008); *see also* Deductibility, Substantiation, and Disclosure of Certain Charitable Contributions, 61 Fed. Reg. 65,946, 65,947 (Dec. 16, 1996) ("Section 1.170A-1(h) of the final regulations incorporates the two-part test adopted by the Supreme Court in *United States v. American Bar Endowment,* 477 U.S. 105 (1986), for determining deductibility under section 170(a) of a payment that is partly in consideration for goods or services.").

54. Treas. Reg. § 1.170A-1(h)(1). The preambles to the proposed and final regulations echoed this rule. *See* Deductibility, Substantiation, and Disclosure of Certain Charitable Contributions, 60 Fed. Reg. 39,896, 39,897 (proposed Aug. 4, 1995) ("[F]or a charitable contribution deduction to be allowed, a taxpayer must intend to make a payment in an amount that exceeds the fair market value of the goods or services received in return, and must actually make a payment in an amount that exceeds the fair market value."); Deductibility, Substantiation, and Disclosure of Certain Charitable Contributions, 61 Fed. Reg. 65,946, 65,947 (Dec. 16, 1996) ("A deduction is not allowed for a payment to charity in consideration for goods or services except to the extent the amount of the payment exceeds the fair market value of the goods or services.").

55. Treas. Reg. § 1.170A-13(f)(6).

56. *Id.* § 1.170A-1(h)(2)(i)(B).

regulations plainly contemplate that quid pro quo transactions involve reciprocal transfers between two parties.

Congress also understands quid pro quo transactions this way. Section 6115(b) defines a "quid pro quo contribution" as "a payment made partly as a contribution and partly in consideration for goods or services provided to the payor by the donee organization."[57] This statutory definition, which helps implement disclosure requirements for Section 170 contributions, shows Congress's focus on benefits provided "by the donee organization[s]."[58] Only they must provide written statements to donors.[59] Had Congress believed that quid pro quo concerns arise when a taxpayer receives a benefit from third parties, it probably would have enacted disclosure rules for them. But it did not.

To defend its awkward quid pro quo definition, the preamble to the SALT regulations cites *Singer v. United States*.[60] That case, the IRS believes, allows third-benefits to reduce the charitable contribution deduction.[61] Thus, when a state government provides a tax credit to a taxpayer for a private charity donation, the proposed regulations limit her deduction.

But *Singer* reflects a weak source of authority for that approach. That case, decided by the Claims Court in 1971, arose before the Supreme Court explained quid pro quo principles in *American Bar Endowment*, before the Treasury codified those principles, and before Congress echoed them. Even if *Singer* were correctly decided at the time, it cannot overcome these later authorities.[62]

57. I.R.C. § 6115(b) (2012).

58. *Id.*

59. Section 6115(a)(1) requires that the donee organization provide a written statement to the donor advising that the charitable contribution deduction for any quid pro quo contribution will be "limited to the excess of the amount" transferred by the taxpayer "over the value of the goods or services provided by the organization." This helps the donor compute her appropriate Section 170(a) deduction. *See id.*; *see also* Treas. Reg. § 1.170A-1(h)(4) (illustrating that the taxpayer may rely on Section 6115 statements in computing the charitable contribution deduction for quid pro quo contributions).

60. Contributions in Exchange for State or Local Tax Credits, 83 Fed. Reg. 43,563, 43,563 (proposed Aug. 27, 2018) (to be codified at 26 C.F.R. pt. 1) (citing Singer Co. v. United States, 449 F.2d 413, 422–23 (Cl. Ct. 1971)).

61. *Id.*

62. In *American Bar Endowment*, the Court cited *Singer*, but only for the proposition that the "payment of money generally cannot constitute a charitable contribution if the contributor expects a substantial benefit *in return*." United States v. Am. Bar Endowment, 477 U.S. 105, 116 (1986) (emphasis added); *see also* Contributions in Exchange for State or Local Tax Credits, 83 Fed. Reg. at 43,563 (noting that the Supreme Court cited *Singer* for that proposition). Nothing in *American Bar Endowment* allows the IRS to reduce deductions for third-party benefits. For that proposition, the regulatory preamble cites only *Singer*. *See id.* ("[T]he benefits received need not come directly from the donee to reduce the allowable deduction, nor do they need to be specifically quantifiable at the time of transfer. *See, e.g.*, *Singer*, 449 F.2d at 422."). Even if *Singer* could otherwise overcome *American Bar Endowment*, codified agency policy, and inferences from Section 6115(b), it is debatable whether the Claims Court adopted the broad principle asserted

The IRS knows this. In *Tempel v. Commissioner*,[63] the IRS successfully argued that quid pro quo principles do not apply to the private charity strategy.[64] The taxpayers in that case had donated property to a private charity and were entitled to transferable state tax credits for their donation.[65] When the taxpayers later sold their credits, they argued that their basis should include the transaction costs associated with their donation.[66]

But the IRS argued otherwise. It contended that the taxpayers' state tax credits did not arise from a "sale or exchange" or from a "quid pro quo transaction."[67] Thus, the IRS argued, the taxpayers did not enjoy a cost basis in their credits.[68]

The Tax Court accepted the IRS's position, emphasizing that the taxpayers "did not acquire the State tax credits by purchase."[69] The state had simply made a "unilateral decision" to grant them credits for their donation.[70] Thus, the taxpayers' basis in their state tax credits did not include their transaction costs.

The proposed SALT regulations conflict with *Tempel* and *American Bar Endowment*. Although an administrative agency may sometimes depart from prior judicial interpretations,[71] the IRS likely cannot do so here. In analogous circumstances, the Supreme Court has expressly rejected an IRS attempt to override its prior holding. To borrow language from that case, *American Bar Endowment* "has already interpreted the statute, and there is no longer any different construction that is consistent with [the Court's prior case law] and available for adoption by the agency."[72] Also, though *American Bar Endowment*

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by the IRS. *See* Lawrence Zelenak, *SALT Ceiling Workarounds and Tax Shelters*, 89 ST. TAX NOTES 365, 372–73 (2018) (arguing that *Singer* and other cases do not support reducing the charitable contribution deduction for benefits received independently from third parties).

63. Tempel v. Comm'r, 136 T.C. 341 (2011), *aff'd sub nom.* Esgar Corp. v. Comm'r, 744 F.3d 648 (10th Cir. 2014).

64. *See id.* at 353.

65. *See id.* at 342–43.

66. *See id.* at 343.

67. *Id.* at 344.

68. *Id.* at 343–44.

69. *Id.* at 353.

70. *Id.* at 353.

71. *See* Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 982 (2005) ("A court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute.").

72. United States v. Home Concrete & Supply, LLC, 566 U.S. 478, 487 (2012). The Justices issued two separate opinions to explain why they rejected the IRS's attempt to override *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958). *See id.* at 478–79. A four-Justice plurality examined several factors that would largely apply in the present context. *See id.* at 488–90 (Breyer, J., plurality) (noting, among other things, that the Court's prior opinion rested on traditional tools of statutory construction, including legislative history, and that principles of stare decisis favored adhering to precedent). Justice Scalia's concurrence flatly rejected an agency's ability to override prior, de novo judicial interpretations. *See id.* at 492 (Scalia, J., concurring).

cited IRS Revenue Rulings, among other things, the Court's holding rested on its independent interpretation of the statute, not on any deference principles.[73] The Supreme Court has thus resolved any ambiguity allegedly identified in *Singer* and which the IRS could otherwise address.

If the IRS finalizes the proposed SALT regulations as written, it will have set them up for a potential attack. Quid pro quo principles cannot apply to the private charity strategy. If the IRS codifies that approach, a court should invalidate the regulations, either in whole or in part.[74]

Admittedly, because different courts take different approaches to administrative deference questions, any legal challenge necessarily faces uncertainty. But even if the IRS can reduce Section 170(a) contributions for third-party benefits, the proposed regulations, if made final, could fail under the "arbitrary and capricious" standard.[75] Under the current regulations, third-party benefits do not reduce deductions.[76] The new regulations will have thus created a rule that applies only to state tax credits. Absent any explanation or justification for this carveout, the final regulations should be invalidated.

None of this means that the IRS must bless the benefits claimed under the private charity strategy. Rather, it need only observe its statutory authority. And the IRS's prior practices provide a sound way to do so. As the IRS successfully argued in *Snyder v. Commissioner*,[77] the grant of a state tax credit may create gross income.[78] If the IRS returns to that since-abandoned position and issues regulations under Section 61, the benefits under the private charity

73. *See* United States v. Am. Bar Endowment, 477 U.S. 105, 118 (1986) (concluding that the trial court below, and not the appellate court, had "applied the proper standard. The *sine qua non* of a charitable contribution is a transfer of money or property without adequate consideration."). *Brand X* principles apply most strongly when a lower court defers to a regulation's permissible construction of a statute and the agency later changes that interpretation. *See Brand X*, 545 U.S. at 981. *Brand X* has not yet allowed an agency to overturn the Supreme Court's de novo construction of a statute.

74. If the private charity strategy regulations were inseparable from the government charity strategy regulations, then a court could potentially set the entire project aside. *See* E. Donald Elliot & Charles W. Tyler, *Administrative Severability Clauses*, 124 YALE L.J. 2286, 2296–97 (2015) (discussing judicial standards for determining whether one part of a regulation may be inseverable from the whole). However, regulatory severability principles have not been tested in the tax law.

75. *See* Encino Motorcars, LLC v. Navarro, 136 S. Ct. 2117, 2120 (2016) (emphasizing that "[a]n 'unexplained inconsistency' in agency policy is 'a reason for holding an interpretation to be an arbitrary and capricious change from agency practice,'" and that "[a]n arbitrary and capricious regulation of this sort is itself unlawful and receives no *Chevron* deference" (quoting *Brand X*, 545 U.S. at 981)).

76. *See supra* notes 60–62 and accompanying text.

77. Snyder v. Comm'r, 55 T.C.M. (CCH) 1334 (1988), *vacated and remanded*, No. 89-1276, 1990 WL 6953 (6th Cir. Feb. 1, 1990).

78. *See id.*

strategy would be denied.[79] Taxpayers might enjoy a Section 170(a) deduction for their creditable donations, but the related income inclusion would wash out that benefit.

More generally, a Section 61 approach provides a better way to address charitable contributions and third-party benefits than does the *Singer* approach. If a taxpayer transfers $100 to a Section 170(c) organization and a third party independently transfers $20 to her for doing so, it makes little sense to say that the taxpayer has made only an $80 contribution. The organization, after all, now has $100 in its hands and would ordinarily report a contribution of that amount.[80] To prevent improper tax benefits, the IRS should allow the taxpayer a $100 deduction but also require that she include $20 in income, unless an exclusion otherwise applies. This income-based approach will withstand regulatory challenges that the awkward *Singer*-based approach might not.

IV. CONCLUSION

The IRS has rightly expressed concerns over the tax benefits asserted under the government charity and private charity strategies. And the IRS has pursued its concerns in a difficult political environment. Thus, the agency deserves credit for weathering the storm.

However, the proposed regulations leave major gaps that will confuse taxpayers and cause administrative headaches for the IRS. Taxpayers will be told that they cannot deduct payments made in consideration for state tax credits, but they will know little else. The IRS should address the further tax consequences associated with acquired state tax credits.

The IRS should also recognize that the government charity strategy and the private charity strategy raise conceptually different issues, and that they require distinct regulatory solutions. The IRS's attempt to address both strategies with a single quid pro quo approach raises technical problems and threatens the validity of any final regulations. To avoid protracted litigation, the IRS should address the private credit strategy in a way consistent with its statutory authority.

79. For further discussion on when and how state tax credits may be included in gross income, see Grewal, *supra* note 7, Sections II.B & III.A.ii.

80. Section 6033 establishes a reporting regime for organizations exempt from tax under Section 501. I.R.C. § 6033 (2012). Organizations enjoying a tax exemption by reason of Section 501(c)(3) must report their total contributions to the IRS. *See* I.R.C. § 6033(b)(5). Section 501(c)(3) organizations will commonly be described in Section 170(c)(2).