TAX TREATMENT OF CHARITABLE CONTRIBUTIONS & STATE TAX CREDITS

By Kirk J. Stark*

Like the federal government, most states offer tax incentives for charitable giving. These incentives typically take the form of an income tax deduction, though states sometimes provide more generous tax incentives in the form of tax credits for some subset of gifts. A review of state tax codes reveals over 100 state charitable tax credits in 33 states.¹

As an example, 18 states provide tax credits for donations to organizations authorized by state law to provide tuition scholarships to students who attend private schools, including sectarian schools.² Because these credits substantially reduce (and in some cases eliminate) the net cost of the gift to the donor, a natural question is whether the donor may claim a charitable contribution deduction on her federal income tax return and, if so, what the amount of the deduction should be. Under current law, expressed in various administrative and judicial pronouncements over the years, taxpayers may claim a deduction for the full amount of a charitable contribution, undiminished by the value of tax savings generated by making the gift. In a recent paper, we refer to this feature of current law as the Full Deduction Rule.³

The recently enacted $10,000 limit on the deductibility of state and local taxes (SALT) has drawn new attention to the legal underpinnings of the Full Deduction Rule.⁴ Some have expressed concern that this rule may allow taxpayers to circumvent the limits on SALT deductibility. For example, consider a taxpayer who makes a $10,000 gift that qualifies for a 30% state tax credit, reducing her SALT liability by $3,000. If she is allowed a $10,000 deduction for this gift on her federal return, she has managed to convert $3,000 of nondeductible taxes into a deductible gift.⁵ Of course the same might be said of the federal charitable contribution deduction itself. A donor

---


² For a summary of these programs, see School Choice in America Dashboard, EdChoice (Jan. 18, 2016), https://www.edchoice.org/school-choice/school-choice-in-america/## [https://perma.cc/264D-8USJ]. Among the states that provide this type of tax credit, several provide donors with a 100% tax credit for qualifying gifts — including Alabama, Arizona, Georgia, and South Carolina. Other states offer somewhat less generous tuition scholarship tax credits—e.g., Oklahoma (75%), Virginia (65%), Iowa (65%), and Indiana (50%). Some of these school tuition tax credits feature per donor limits, while others do not.

³ See Bankman et al., supra note 1.


⁵ Of course, the millions of taxpayers subject to the AMT before the passage of the new tax law were already in the situation where it would be advantageous to increase the deductible charitable contribution and reduce their non-deductible state and local taxes.
who makes a $10,000 gift is ordinarily entitled to a federal deduction for the full $10,000, despite the fact that the gift reduces her nondeductible federal income tax liability by $3,700 (for a taxpayer in the top bracket). For better or worse, the law seems to have always countenanced this implicit conversion of nondeductible taxes into deductible gifts.

Taxpayers making donations to any of the existing 100+ programs referenced above are understandably interested in knowing the federal income tax consequences of their gifts. For example, consider the “Exceptional SC Fund,” the 501(c)(3) entity established by the South Carolina legislature to receive donations to fund private school tuition scholarships for children with special needs. Assume that taxpayer Jessamine expects to owe $60,000 in South Carolina state income taxes and would like to make a gift to the Exceptional SC Fund. Under South Carolina law, Jessamine could donate $50,000 to the state fund, entitling her to a nonrefundable tax credit in the same amount when filing her state income tax return. Assuming the Full Deduction Rule applies, Jessamine’s federal return would include a $10,000 deduction for SALT paid and a $50,000 charitable contribution deduction. Is Jessamine entitled to claim a $50,000 charitable contribution deduction for her donation to the Exceptional SC Fund? If not, what is the proper treatment of her $50,000 donation?

As an extension of the example above, assume that Connecticut establishes a Bridgeport School District Fiscal Support Fund and that donors to this fund will be entitled to an 80% nonrefundable state tax credit for their donations. Assume that taxpayer Laurel makes a $10,000 gift, entitling her to an $8,000 credit on her Connecticut income tax return. May Laurel deduct the full $10,000 as a charitable contribution on her federal return? Does the answer to that question depend on the amount of Laurel’s Connecticut income tax liability determined without regard to the credit? For example, what if Laurel’s pre-credit income tax liability is $5,000, such that the $8,000 credit will reduce her 2018 liability to zero, leaving $3,000 of unused credit to be carried over to her 2019 return.

If Jessamine and Laurel are required to reduce their charitable contribution deductions by the value of the state tax credits generated by making the gifts described above, must they also reduce their deductions by the value of the federal charitable contribution deduction itself? Like state and local taxes beyond the $10,000 limit, federal income taxes are nondeductible. If the Full Deduction Rule is to be rejected in the context of state/local charitable tax incentives (to prevent taxpayers from converting nondeductible SALT to deductible gifts), should it also be rejected in the context of the federal charitable tax incentive (to prevent taxpayers from converting nondeductible federal taxes to deductible gifts)? If so, how would this work?

---

6 The formal name of the Exceptional SC Fund is the South Carolina Educational Credits for Exceptional Needs Children Fund. The Fund is governed by five directors, two of whom are appointed by Chairman of the South Carolina House Ways and Means Committee, two by the Chairman of the South Carolina Senate Finance Committee, and one appointed by the Governor.

7 According to the Education Law Center, Bridgeport School District in Connecticut is one of “the most fiscally disadvantaged districts in the country.” BRUCE BAKER ET AL., IS SCHOOL FUNDING FAIR? AMERICA’S MOST FISCALLY DISADVANTAGED SCHOOL DISTRICTS 4 (2016).

8 I.R.C. § 275(a)(1).
Finally, if some sort of federal action is appropriate to clarify or modify the tax consequences of gifts to these programs, what form should that federal action take? Should the IRS issue a notice along the lines of its December 2017 notice regarding prepayment of property taxes? Given extant law and guidance, could the IRS change its position substantially via such a notice? Should the Treasury Department initiate notice and comment procedures to promulgate new regulations? And again, what changes are possible through regulation, given existing law? Should Congress change the law? If so, how?