THE WAYS OF PARADOX: WHAT RENDERS A CONTRIBUTION DEDUCTIBLE?

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I. BACKGROUND

In his prompt, Professor Stark serves up a most ingenious paradox: if a charitable contribution must be disinterested to qualify for the federal charitable deduction, which confers a tax benefit, does not the very act of claiming the deduction render the claimant ineligible for it? Groucho Marx did not care to belong to any club that would have him as a member; the charitable deduction, in turn, is transformed into the deduction which will not countenance any contribution it deems eligible.

Clearly, this is neither the intent nor the reality of the charitable deduction, nor does Professor Stark suppose it to be. But even nonsense can be suggestive,¹ so might the seeming paradox aid us in unraveling the entwined threads of Internal Revenue Code provisions, Treasury regulations, case law, Internal Revenue Service (IRS) guidance, and actual practice? Might it help clarify whether state legislative proposals enabling taxpayers to recharacterize state tax payments as charitable contributions differ in essence or merely in magnitude from existing state tax credits, or indeed whether the current treatment of those incentivized contributions is legally justified?

Proponents of federal tax reform expressed optimism that changes to the tax code would spark innovation. If legislative innovation counts, the new law is already an unqualified success, with states actively pursuing multiple strategies to enable their residents to avoid the law’s $10,000 limit on the deductibility of state and local taxes (SALT). Under one approach developed by Professor Stark and others,² taxpayers would be permitted to make voluntary charitable contributions to a governmental fund then take that amount as a credit against state taxes. State tax liability, nondeductible above the cap, is converted into a deductible charitable contribution, essentially preserving the full value of the deduction for eligible taxpayers.

Critics have dismissed this as little more than a recharacterization which would be regarded by the IRS as the satisfaction of tax liability, not charity. Against this, Professor Stark offers his paradox, along with the evidence of more than one hundred state tax credits for contributions to scholarship organizations, free clinics, food pantries, and other charities,³ all of which undeniably reduce (and occasionally even eliminate) the net cost of

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the gift to the donor, and none of which have been interpreted to limit the amount of the contribution eligible for the federal deduction. How can the aforementioned legal constraints be reconciled with the practice of countless taxpayers who have claimed the charitable deduction for contributions favored by state credits?

II. GENERAL REQUIREMENTS

Both private nonprofits and governmental entities are qualifying organizations for purposes of the charitable deduction, but contributions to government are only deductible if the contribution “is solely for public purposes (for example, a gift to reduce the public debt or maintain a public park).”4 The requirement that contributions have a charitable aspect creates an immediate obstacle to contribution-in-lieu-of-taxes proposals, as such contributions serve little or no public purpose (a 100% credit has no net effect on state revenue) and are primarily intended to benefit the donor, not the recipient.

U.S. Treasury regulations also prohibit claiming contributions from which the donor benefits, at least to the extent of that benefit.5 If one purchases a $250 ticket to a benefit dinner, and the fair market value of the dinner is $50, then only $200 can be deducted.6 In Professor Stark’s scenario, arguably the personal benefit of Laurel’s $10,000 contribution is the $8,000 credit she received against Connecticut tax liability, making $2,000 the most she could deduct for federal tax purposes, undermining the intent of the credit.

Furthermore, the Internal Revenue Code stipulates that if a liability is assumed by the recipient as the result of a charitable contribution, the deductible value of the charitable contribution is reduced by the amount of that liability.7 Even neglecting the limitations discussed above, the liability undertaken by the state—in the form of a tax credit—could provide the basis for disallowing the deduction.

Extant case law creates further barriers to such strategies. In Singer Company v. United States, the U.S. Court of Claims ruled that a payment of money generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return.8 Similarly, the U.S. Supreme Court has held that when a charitable contribution has a dual character, a “taxpayer… must at a minimum demonstrate that he purposely contributed money or property in excess of the value of any benefit he received in return” for any portion of the contribution to be deductible.9 These holdings could disallow Laurel’s entire deduction, not just limit it to $2,000.

Still worse for Laurel’s chances, IRS regulations in a matter regarding personal property taxes provide that “[a] tax may be considered to be imposed in respect of personal property even if in form it is imposed on the exercise of a privilege,”10 while an appellate

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5 Specifically, those regulations stipulate that “[a] 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 … 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.” Treas. Reg. §26 CFR 1.170A-1(h).
6 Id.
7 I.R.C. § 170(f)(5).
8 The Singer Co. v. U. S., 449 F.2d 413 (Ct. Cl. 1971).
10 Treas. Reg. § 1.164-3(a)(3).

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case spells out the rule more generally: “whether a particular contribution or charge is to be regarded as a tax depends upon its real nature." The IRS would be well within its authority to determine, consistent with the doctrine of substance over form, that the payment, though recharacterized as a charitable contribution, is nothing more than satisfaction of tax liability.

III. THE CHARITABLE TAX CREDIT CONUNDRUM

In Professor Stark’s other scenario, Jessamine contributes $50,000 to a scholarship organization, which funds private school tuition scholarships for children with special needs. She receives a dollar-for-dollar credit against her state income tax liability for this contribution, then claims a $50,000 deduction against federal tax liability, with the seemingly perverse result that her financial position is enhanced by her contribution. This anomalous outcome is consistent with the intent of SALT deduction avoidance proposals, in which contributions yield an increase in the donor’s after-tax income, and seems at odds with the legal determinants of a qualifying charitable contribution. Here, then, is another paradox.

Is the IRS’s current permissive treatment of Jessamine’s contribution mistaken, and can it be distinguished from the contributions-in-lieu-of-taxes proposals emerging in California, New Jersey, and other states?

Paradox has been defined as “truth standing on her head to attract attention,” and such an outcome succeeds by that measure. Most observers are likely to rankle at the notion that a financial transaction to one’s advantage is considered an act of charity; it fails to accord with what Professor Stark has termed “the common-sense notion that a charitable gift entails parting with something of value.” In 2013, he called attention to possible arbitrage opportunities, though their potential benefit was much attenuated prior to the limitation of the SALT deduction.

It is possible that the IRS has been too lenient with existing charitable credits and that the amount claimed for purposes of the federal tax deduction should be prorated based on the generosity of the state benefit. The IRS has diligently avoided issuing formal guidance on this matter, though full deductions have been permitted in practice. For our purposes, however, it is enough if these programs can be distinguished from those expressly designed to facilitate a reduction in the donor’s federal tax liability.

The existing tax credits to which proposed SALT deduction limitation avoidance credits are often analogized almost exclusively incentivize contributions made not to the state but to private charities. They do reduce state tax liability, often quite significantly, but

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11 Campbell v. Davenport, 362 F.2d 624, 628 (5th Cir. 1966).
15 Phillip Blackman and Kirk J. Stark, Capturing Federal Dollars with State Charitable Tax Credits, TAX NOTES (April 1, 2013) [https://perma.cc/S8RF-QKTC].
16 Id.
17 I.R.S. Chief Counsel Advice, 2011-05-010 (released Feb. 4, 2011), https://www.irs.gov/pub/irs-wd/1105010.pdf [https://perma.cc/9UAE-UEXG] (“In both instances we did not resolve the issue, but instead suggested that the issue could be addressed in official published guidance. At this time, published guidance on the issue is not contemplated.”).
they do so by leaving the state treasury worse off rather than making it whole. By contrast, contributions-in-lieu-of-taxes proposals are designed to leave governmental revenues unchanged. Contributions to 501(c)(3) organizations, however heavily subsidized by state governments, benefit the recipient, thus meeting one key test of a charitable contribution. Conversely, contributions to governmental entities that are offset by a corresponding tax credit do not benefit the recipient, or do so only at the margin (where the credit is less than 100%). The former involves the state forgoing revenue to promote a charitable cause; the latter involves only the recharacterization of a payment already being made.

Relatedly, when governments provide a tax credit for contributions to private charity, the liability (in the form of the credit), while substantial, is not incurred by the recipient (the charity). The same cannot be said when the government is also the recipient.

An IRS memorandum on state charitable tax credits notes that state tax benefits are generally treated as a reduction in state tax liability reflected in a reduced SALT deduction. This memo, while nonprecedential, is often cited by proponents of SALT deduction cap workarounds, as it tacitly permits many of the extant credit programs. However, the logic of the memo is predicated on the notion that recharacterization has little or no impact on federal liability, a supposition which no longer holds.

The memo also sets out several guardrails, noting that “[a] transfer is not made with charitable intent if the transferor expects a direct or indirect return benefit commensurate with the amount of the transfer,” and that “[i]f the benefits expected to be received by a donor are substantial (that is, greater than those incidental benefits that inure to the general public from transfers for charitable purposes), then the transferor has received a quid pro quo sufficient to remove the transfer from the realm of deductibility.” The memo even posits 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.”19 If contributions-in-lieu-of-taxes do not constitute such circumstances, it is difficult to imagine what would.

Finally, while the act of claiming the federal deduction may be inherently in tension with the idea of a completely disinterested charitable contribution, this cannot allow the many limitations with which the deduction is fenced to become a dead letter. There can be no question that the deduction is intended to incentivize and reward charitable giving and that this tax preference does not sufficiently encumber the contribution as to render it ineligible. Perhaps it is this same line of thought which has kept the IRS from adopting more stringent rules about state tax credits incentivizing charitable activity. A measure of permissiveness does not require a total indifference to whether a contribution exhibits anything approaching a charitable aspect.

IV. CONCLUSION

For the laws, regulations, and case law around eligible charitable contributions to have any meaning, they cannot countenance contributions expressly devised to reduce tax liability, with little or no benefit inuring to the recipient. To permit a deduction would not be to play at paradox but to make existing requirements a nonsense.

The Internal Revenue Code requires no such outcome. “A charitable contribution,” it specifies, “shall be allowable as a deduction only if verified under regulations prescribed

18 Id.
19 Id.
by the Secretary.”20 Existing law, regulations, and case law provide ample grounds to disallow contributions so frankly proffered as tax avoidance schemes. Issuance of a notice clarifying these restrictions would be appropriate and consistent with current law and regulation. The federal government is under no obligation to affirm tax avoidance schemes which rely on an inversion of the plain meaning of charitable giving.

20 I.R.C. § 170(a).