

Guidance Providing a Safe Harbor Under Section 164 for Certain Individuals Who Make a Payment to or for the Use of an Entity Described in Section 170(c) in Return for a State or Local Tax Credit

Notice 2019-12

SECTION 1. PURPOSE

This notice announces that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to publish a proposed regulation providing a safe harbor under section 164 of the Internal Revenue Code (Code) for certain individuals who make a payment to or for the use of an entity described in section 170(c) in return for a state or local tax credit. Under the safe harbor, an individual may treat as a payment of state or local tax for purposes of section 164 the portion of a payment for which a charitable contribution deduction under section 170 is or will be disallowed under Treas. Reg. § 1.170A-1(h)(3) (T.D. 9864). This treatment as a payment of state or local tax under section 164 is allowed in the taxable year in which the payment is made to the extent the resulting credit is applied, consistent with applicable state or local law, to offset the individual's state or local tax liability for such taxable year or the preceding taxable year. In states and localities that permit an individual to carry forward an excess credit amount to a subsequent taxable year, an individual may treat the carryforward amount as a state or local tax payment under section 164 for the taxable year or years to which the credit is applied, consistent with applicable state or local law, to offset a state or local tax liability. Prior to issuance

of the proposed regulation, taxpayers may rely on the provisions of this notice with respect to payments described in this notice.

SECTION 2. BACKGROUND

Section 170(a)(1) generally allows an itemized deduction for any “charitable contribution” paid within the taxable year. Section 170(c) defines “charitable contribution” as a contribution or gift to or for the use of any entity described in that section. Under section 170(c)(1), such an entity includes a State, a possession of the United States, or any political subdivision of the foregoing, including the District of Columbia. Section 170(c)(2) includes certain corporations, trusts, or community chests, funds, or foundations, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals.

Section 164(a) allows a deduction for the payment of certain taxes, including: (1) state and local, and foreign, real property taxes; (2) state and local personal property taxes; and (3) state and local, and foreign, income, war profits, and excess profits taxes. Section 164(b)(6), as added by section 11042(a) of “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018” (“the Act”), Pub. L. 115-97, provides that deductions for foreign real property taxes are not allowable under section 164(a)(1) and limits an individual’s deduction to \$10,000 (\$5,000 in the case of a married individual filing a separate return) for the aggregate amount of the following state and local taxes paid during the calendar year: (1) real property taxes; (2) personal property taxes; (3) income, war profits, and excess profits taxes; and (4) general sales taxes. This limitation applies to taxable years beginning

after December 31, 2017, and before January 1, 2026, and does not apply to foreign taxes described in section 164(a)(3) or to any taxes described in section 164(a)(1) and (2) that are paid and incurred in carrying on a trade or business or an activity described in section 212. Section 164(b)(2) provides that for purposes of section 164, a “state or local tax” includes only a tax imposed by a state, a United States territory, or a political subdivision of any of the foregoing, or by the District of Columbia.

Due to the potential for taxpayers to use state or local tax credit programs to avoid the limitation on the deductibility of state and local taxes, the Treasury Department and the IRS have issued guidance on the federal income tax treatment of transfers to entities described in section 170(c) when the taxpayer receives or expects to receive a state or local tax credit in return. On June 11, 2018, the Treasury Department and the IRS issued Notice 2018-54, 2018-24 I.R.B. 750, announcing the intention to propose regulations addressing the federal income tax treatment of transfers pursuant to state and local tax credit programs. On August 27, 2018, proposed regulations under sections 170 and 642(c) were published in the Federal Register (83 FR 43563). The proposed regulations generally state that if a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c), and the taxpayer receives or expects to receive a state or local tax credit in return for such payment, the tax credit constitutes a return benefit, or quid pro quo, to the taxpayer and reduces the taxpayer’s charitable contribution deduction under section 170(a). On December 28, 2018, the Treasury Department and the IRS issued Rev. Proc. 2019-12, 2019-04 I.R.B. 401, providing a safe harbor under section 162 for certain payments made by C corporations and specified passthrough entities to or for the use

of an organization described in section 170(c) if the C corporation or specified passthrough entity receives or expects to receive a state or local tax credit in return for such payment. On June 11, 2019, the Treasury Department and the IRS published T.D. 9864, Contributions in Exchange for State or Local Tax Credits, 2019-27 I.R.B. (effective August 12, 2019 and applicable to amounts paid or property transferred by a taxpayer after August 27, 2018), providing rules governing the availability of charitable contribution deductions under section 170 when a taxpayer receives or expects to receive a corresponding state or local tax credit, as well as providing similar rules under section 642(c) for payments made by a trust or decedent's estate.

In the Special Analyses section of the proposed regulations, the Treasury Department and the IRS explained that the proposed regulations “will leave charitable giving incentives entirely unchanged for the vast majority of taxpayers.” The Treasury Department and the IRS acknowledged, however, that a small fraction of taxpayers could see a reduction in their financial incentives to donate to state and local tax credit programs compared to their pre-Act incentives and requested comments on this important consideration. After the publication of the proposed regulations, stakeholders expressed concern, through comments and through testimony at the public hearing, that the proposed regulations would create unfair consequences for certain individuals who receive state or local tax credits in return for payments to section 170(c) entities. Specifically, donors to such tax credit programs who itemize deductions for federal income tax purposes and have total state and local tax liability for the year under \$10,000 would be precluded from taking charitable contribution deductions for payments to section 170(c) entities to the extent the donors receive state or local tax

credits even though the donors would have been able to deduct equivalent payments of state and local taxes offset by such credits. As a result of the proposed regulations, if these individuals chose to make a payment to a section 170(c) entity instead of paying tax to the state or local government, they would lose a deduction to which they would otherwise have been entitled.

These state tax credit programs effectively offer taxpayers a choice of paying tax to the state or local government or making a payment to a section 170(c) entity and receiving a tax credit that offsets the taxpayer's state or local tax liability. This situation can be analogized to situations in which a party entitled to receive a payment from a second party directs or permits the second party to satisfy its payment obligation by making a payment to a third party. In such situations, the payment may be treated, for federal income tax purposes, as a payment by the payor to the party entitled to receive payment. Cf. Rev. Rul. 74-75, 1974-1 C.B. 19 (payment made by an employer to a third party to discharge an obligation of an employee treated for federal income tax purposes as made by the employer to the employee); Rev. Rul. 86-14, 1986-1 C.B. 304 (same).

SECTION 3. SAFE HARBOR FOR INDIVIDUALS

The Treasury Department and the IRS take seriously the concern that the proposed regulations could create unfair consequences for individuals who (i) itemize deductions for federal income tax purposes, (ii) make a payment to a section 170(c) entity in return for a state or local tax credit, and (iii) would have been able to deduct a payment of tax to the state or local government in the amount of the credit. A safe harbor is appropriate to mitigate the consequences of the proposed regulations in the situation described above.

Accordingly, the Treasury Department and the IRS intend to publish a proposed regulation amending Treasury Regulation § 1.164-3 to provide a safe harbor for certain individuals who make a payment to or for the use of an entity described in section 170(c) in return for a state or local tax credit. Under this safe harbor, an individual who itemizes deductions and who makes a payment to a section 170(c) entity in return for a state or local tax credit may treat as a payment of state or local tax for purposes of section 164 the portion of such payment for which a charitable contribution deduction under section 170 is or will be disallowed under final regulations. This treatment as a payment of state or local tax under section 164 is allowed in the taxable year in which the payment is made to the extent the resulting credit is applied, consistent with applicable state or local law, to offset the individual's state or local tax liability for such taxable year or the preceding taxable year.¹ To the extent the resulting credit is not applied to offset the individual's state or local tax liability for the taxable year of the payment or the preceding taxable year, any excess credit permitted to be carried forward may be treated as a payment of state or local tax under section 164 in the taxable year or years for which the carryover credit is applied, consistent with applicable state or local law, to offset the individual's state or local tax liability. This safe harbor shall not apply to a transfer of property.

Nothing in this notice may be construed as permitting a taxpayer who applies this safe harbor to treat the amount of any payment as deductible under more than one provision of the Code or Treasury regulations.

¹ Some state or local tax credit programs allow an individual to apply the state or local tax credit to offset a prior year's state or local tax liability.

Nothing in this notice may be construed as permitting a taxpayer who applies this safe harbor to avoid the limitations of section 164(b)(6) for any amount paid as a tax or treated under this notice as a payment of tax.

SECTION 4. EXAMPLES

In the examples below, assume that the taxpayer's application of the state or local tax credit is consistent with applicable state or local law and that the taxpayer is an individual who itemizes deductions for federal income tax purposes.

Example 1. In year 1, Taxpayer A makes a payment of \$500 to an entity described in section 170(c). In return for the payment, A receives a dollar-for-dollar state income tax credit. Prior to application of the credit, A's state income tax liability for year 1 was \$500 or more; A applies the \$500 credit to A's year 1 state income tax liability. Under section 3 of this notice, A treats the \$500 payment as a payment of state income tax in year 1 for purposes of section 164. To determine A's deduction amount, A must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6).

Example 2. In year 1, Taxpayer B makes a payment of \$7,000 to an entity described in section 170(c). In return for the payment, B receives a dollar-for-dollar state income tax credit, which under state law may be carried forward for three taxable years. Prior to application of the credit, B's state income tax liability for year 1 was \$5,000; B applies \$5,000 of the \$7,000 credit to B's year 1 state income tax liability. Under section 3 of this notice, B treats \$5,000 of the \$7,000 payment as a payment of state income tax in year 1 for purposes of section 164. Prior to application of the remaining credit, B's state income tax liability for year 2 exceeds \$2,000; B applies the

excess credit of \$2,000 to B's year 2 state income tax liability. For year 2, B treats the \$2,000 as a payment of state income tax for purposes of section 164. To determine B's deduction amounts in years 1 and 2, B must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6).

Example 3. In year 1, Taxpayer C makes a payment of \$7,000 to an entity described in section 170(c). In return for the payment, C receives a local real property tax credit equal to 25 percent of the amount of this payment (\$1,750). Prior to application of the credit, C's local real property tax liability in year 1 was \$3,500; C applies the \$1,750 credit to C's year 1 local real property tax liability. Under section 3 of this notice, for year 1, C treats \$1,750 as a payment of local real property tax for purposes of section 164. To determine C's deduction amount, C must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6).

SECTION 5. APPLICABILITY DATE

The proposed regulation setting forth the safe harbor described in this notice will apply to payments made to section 170(c) entities after August 27, 2018. Prior to the issuance of that proposed regulation, taxpayers may rely on the provisions of this notice with respect to such payments.

SECTION 6. REQUEST FOR COMMENTS

The Treasury Department and the IRS request comments on the safe harbor described in this notice by July 11, 2019. Taxpayers may submit comments electronically via the Federal eRulemaking Portal at www.regulations.gov (type IRS-

2019-0020 in the search field on the www.regulations.gov homepage to find this notice and submit comments). Alternatively, taxpayers may submit comments to:

CC:PA:LPD:PR (Notice 2019-12), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C., 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to

CC:PA:LPD:PR (Notice 2019-12), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224. All comments received will be available for public inspection on www.regulations.gov.

SECTION 7. DRAFTING INFORMATION

The principal authors of this notice are personnel from the Office of the Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, contact Mon L. Lam at (202) 317-4059 (not a toll-free call).