Capturing Federal Dollars With State Charitable Tax Credits

By Phillip Blackman and Kirk J. Stark

Phillip Blackman is an associate director of development at the Penn State Dickinson School of Law. Kirk J. Stark is professor of law at the UCLA School of Law. The authors would like to thank David Anderson, Ellen Aprill, Michael Asimow, Calvin Johnson, William Klein, Jason Oh, and Bruce Wolk for comments on earlier drafts of this report. Any errors or omissions are the sole responsibility of the authors.

In this report, Blackman and Stark discuss the federal income tax treatment of state charitable tax credits. A recent chief counsel memorandum found that a taxpayer was permitted to claim a charitable contribution deduction for the full amount of a gift, even though a substantial portion of the gift was effectively refunded to the taxpayer through a charitable state tax credit. Blackman and Stark explain that the memorandum permits states to adopt charitable tax credits that effectively enable taxpayers to convert state taxes to charitable gifts — a strategy that would be attractive to alternative minimum tax payers. Those state charitable tax credits (some with extraordinarily high credit percentages) appear to be on the rise, perhaps in part because they effectively enable a transfer of revenue from the federal government to the states. The authors believe the memorandum should be repudiated (as a matter of appropriate federal tax policy), but if it is not, states should consider taking advantage of it.

Table of Contents

I. Introduction ........................ 53

II. Mechanics of Federal Tax Law ........ 54
A. Charitable Contributions .......... 54
B. Deduction for State and Local Taxes .. 56
C. California AMT Data ............... 57

III. Effects of a State Charitable Tax Credit .. 57

IV. Tax Credit for Donations to Cal Grants .... 62
A. The College Access Tax Credit .......... 62
B. Expanding the (Potential) Benefits of S.B. 284 ................. 63

V. Conclusion ........................ 64

“Bucks loves strategies that allow you to beat the system, especially when you can do some good in the process.”


I. Introduction

In ongoing debates about how to fund state and local public goods, one strategy stands out for its ability to engender bipartisan agreement: more money from the federal government. The Golden State is no exception. Despite pervasive disagreement over the size of government and the level of taxes required to pay for it, Californians are generally united in the view that the state is getting a raw deal vis-à-vis the federal government. Polling data consistently show that roughly two-thirds of Californians think the state should receive more federal assistance, including a majority of Democrats, Republicans, and independents.1 Playing on those sentiments during his gubernatorial campaign in 2003, Arnold Schwarzenegger said, “By the time I’m through with this whole thing, I will not be known as the Terminator — I will be known as the Collectinator!”2 Jerry Brown sounded a similar theme seven years later, vowing to “stop leaving federal money on the table.”3 Whatever the merits of those bipartisan proclamations as a political matter, there is little indication that Washington is prepared to rework the distribution of federal spending or taxes in California’s favor.

1Public Policy Institute of California, “Californians and Their Government” (Jan. 2010).
Importantly, however, not all policies directing additional federal support to the state require congressional approval. This report considers a legislative strategy for increasing federal funds that California, or any other state, could enact on its own initiative: the adoption of a state income tax credit for charitable contributions that augment or defray selected state or local government expenditures. If respected by federal tax authorities, such a credit would enable taxpayers to convert state income tax payments to charitable contributions on their federal income tax returns. That would reduce the federal income tax liability of taxpayers subject to the federal alternative minimum tax, which disallows deductions for state and local taxes but permits them for charitable contributions. Also, if the state were to adopt a transferable charitable tax credit, taxpayers could convert ordinary income to capital gains, reducing their federal income tax liability by as much as 20 cents on the dollar based on current tax rates. In both cases, the state government would share in the federal tax savings to the extent the charitable tax credit does not fully compensate taxpayers for their donations.

While that outcome may sound too good to be true, recent legal guidance from the IRS Office of Chief Counsel appears to support that strategy. Asked to opine on the effects of a state income tax credit for charitable donations, the chief counsel in 2010 concluded that the taxpayer was allowed to deduct the full amount of her charitable contribution to a state agency even though she received a state income tax credit for some (unspecified) percentage of that amount.4 A recent Tax Court decision appears to support the IRS position, accepting a couple’s charitable contribution deduction even though the gift entitled them to a 100 percent state tax credit for a portion of their gift.5 That conclusion is consistent with the federal income tax treatment of state tax deductions for charitable contributions, which are generally ignored in calculating the amount of a donor’s federal deduction, but it is at variance with other legal authority requiring a taxpayer to reduce the amount of her charitable contribution deduction by the amount of cash and the value of any property or services received in exchange for the gift.

Our analysis considers the federal income tax consequences of state charitable tax credits and critically evaluates the chief counsel memorandum on the topic. We consider the significance of the chief counsel’s analysis for S.B. 284, draft legislation recently proposed by California state Sen. Kevin de León (D) that would permit an income tax credit for some contributions to a college access tax credit fund (CATCF). The CATCF program offers a framework for considering how California might take advantage of the chief counsel’s 2010 memorandum. Our analysis casts doubt on the chief counsel’s conclusions and thus also calls into question the federal tax benefits supposedly associated with S.B. 284. Nevertheless, given the IRS’s position, the CATCF program deserves consideration as a way for California to pursue fiscal “self-help” using creative tax planning. While we believe the CATCF strategy should not produce the federal tax benefits it purports to produce, IRS guidance appears to provide a legal opening for those hoping to act on the state’s Collectinator impulses.

II. Mechanics of Federal Tax Law

Understanding the possible benefits to California of adopting an income tax credit for charitable contributions requires a brief overview of relevant federal tax rules, including the deduction for charitable contributions, the deduction for state and local taxes, and the differential treatment of charitable contributions and state and local taxes for purposes of the federal AMT.

A. Charitable Contributions

Section 170 allows a deduction for “any charitable contribution... payment of which is made within the taxable year.”6 Significantly, the statute goes on to define a charitable contribution as a contribution or gift to or for the use of... a state, possession of the United States, or any political subdivision of any of the foregoing... but only if the contribution or gift is made for exclusively public purposes.”7 While charitable gifts to state governments are less common than donations to other types of charitable organizations, the statute is clear that the term “charitable contribution” encompasses those gifts.8

Like all charitable donations, gifts to state and local governments are subject to the general rules

---

4I.R.M 20105010.
6Section 170(a).
7Section 170(c).
8Of course, gifts to state colleges and universities (as well as public schools at the K-12 level) are not uncommon, although those contributions would be deductible as charitable gifts even if the schools were private because the statute permits deductible contributions to educational organizations. For a thorough review of the different types of governmental entities and affiliates for purposes of various federal income tax rules, including the charitable contribution deduction, see Ellen Aprill, “The Integral, the Essential, and the Instrumental,” 23 J. Corp. Law 803 (1998).
and limitations applicable to charitable contributions, including those set forth in Treasury regulations or developed through judicial doctrines over the years. Of particular relevance to our analysis is the limitation in reg. section 1.170A-1(h)(1), providing that “no 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 (as defined in section 1.170A-13(f)(5)) 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.”

That rule accords with the common-sense notion that a charitable gift entails parting with something of value. To the extent that the taxpayer is receiving an item of value in exchange for her contribution, it would seem appropriate to reduce the amount of the taxpayer’s charitable contribution deduction by the FMV of whatever is received. Accordingly, the regulations specify that any otherwise allowable charitable contribution deduction cannot exceed the excess of (1) the amount of any cash and the FMV of any property (other than cash) transferred by the taxpayer to an organization described in section 170(c), over (2) the FMV of the goods or services the organization provides in return.

That approach should be familiar to anyone who has made a donation to organizations such as NPR or PBS during one of their pledge weeks. It is not uncommon for those types of organizations to provide donors with an item of value in exchange for their gift. For example, in exchange for a gift of $500, PBS might send a donor a complete DVD set of the Ken Burns documentary on the Civil War. If that DVD set has an FMV of $100, the taxpayer’s charitable contribution will be limited to $400 — that is, the excess of the amount contributed ($500) over the FMV of the goods received in exchange ($100).

Surprisingly little attention has been given to the interaction between the rules just summarized and the availability of state income tax benefits arising from charitable gifts. It is common for states with an income tax to follow the federal tax code in providing a deduction for charitable contributions. Thus, in the above example, the taxpayer may be able to claim a $400 charitable contribution deduction not only on her federal Form 1040, but also on her state income tax return. Assuming a federal tax rate of 35 percent and a state tax rate of 10 percent, a $400 deduction will reduce the taxpayer’s federal income tax liability by $140 and reduce her state income tax liability by $40.

In most cases, the state tax benefits arising from a charitable donation are not likely to be significant, in part because state income tax rates are much lower than federal income tax rates. Also, the reduction of the taxpayer’s state income tax liability has its own federal income tax consequences — that is, reducing the amount of otherwise deductible state income tax payments. However, matters are complicated — and the stakes potentially increased — when a state offers an income tax credit for charitable gifts rather than a deduction. Unlike a deduction, a credit is a dollar-for-dollar reduction in a taxpayer’s tax liability. Whereas the dollar value of a deduction is a function of the taxpayer’s marginal tax rate, the dollar value of a credit is a function of the credit percentage available under the credit.

For example, assume that a state adopts a 40 percent income tax credit for donations to PBS and taxpayer Dora makes a $1,000 donation to her local PBS station. Assume further that Dora’s marginal tax rate under her state’s income tax is 10 percent. If Dora were to claim a state charitable contribution deduction for her $1,000 donation, it would save her $100 in state income taxes. By contrast, an income tax credit with a 40 percent credit percentage would reduce Dora’s state income tax liability by $400. Deductions and credits are merely two different ways of accomplishing the same result; however, credits give policymakers more flexibility because the subsidy rate can be set independently of marginal tax rates.
Some states have recently adopted state income tax credits with extraordinarily high credit percentages, including some with a 100 percent state income tax credit.\textsuperscript{15} It is worth pausing for a moment to reflect on what it means for a state to offer a 100 percent income tax credit for a charitable gift. Can such a transfer even be considered a "gift"? Returning to our Dora/PBS example, assume that Dora’s state permits a 100 percent income tax credit for donations to PBS up to an amount of $1,000. Under the terms of the statute, a $1,000 "gift" to PBS would let Dora reduce her state income tax liability by $1,000. In effect, Dora is directing the state to transfer $1,000 of what would otherwise be state income tax revenue to PBS.\textsuperscript{16} Such a scheme raises some interesting questions about politics and democratic theory. For example, who should decide how that $1,000 is spent, a state’s elected representatives, or the taxpayers who make those donations? But those questions are beyond the scope of this analysis.

A 100 percent state income tax credit has the dual effect of increasing the taxpayer’s charitable contributions by the amount donated and reducing the taxpayer’s state income tax payments by the same amount. In effect, the availability of a 100 percent state income tax credit for charitable gifts permits the taxpayer to "convert" what would otherwise be state tax payments to charitable donations. When the donee is not a private organization, but rather the state government itself, the only real change is one of labeling. In other words, if Dora makes a $1,000 gift to her state and is thereby allowed to claim a $1,000 state income tax credit, all she really has done is convert what would otherwise have been a $1,000 state income tax liability into a $1,000 charitable gift.

B. Deduction for State and Local Taxes

Under section 164, taxpayers are allowed a deduction for state and local property taxes, income taxes, and in some circumstances, retail sales taxes.\textsuperscript{17} That long-standing provision of federal tax law should negate any benefit associated with converting state income tax payments to a charitable gift. In the example described above, if Dora claims a 100 percent state income tax credit for her $1,000 donation to PBS, all she has done is reduce her (federally deductible) state income taxes and increase her (federally deductible) charitable contributions. Because both state income tax payments (section 164) and charitable contributions (section 170) are deductible for purposes of the federal income tax, converting a $1,000 transfer from one category to the other should have no meaningful federal income tax consequences.

Significantly, however, state income tax payments and charitable contributions are treated differently for purposes of the federal AMT. Whereas charitable contributions are deductible for both the regular income tax and the AMT, state and local taxes are deductible only for the regular income tax. More precisely, section 56(b)(1)(A)(ii) provides that "in determining the amount of the alternative minimum taxable income...no deduction shall be allowed...for any taxes described in paragraph (1), (2) or (3) of section 164(a)." As a result of that provision, taxpayers subject to the AMT typically receive no federal income tax benefit from the deduction for state and local taxes. Thus, while a taxpayer subject only to the regular income tax should generally be indifferent to the classification of a payment as a charitable contribution or a state tax payment, an AMT payer generally will prefer to have a payment classified as a charitable contribution rather than a state tax payment because the former is deductible while the latter is not.\textsuperscript{18}

Until recently, the AMT was a relatively insignificant feature of the U.S. fiscal structure. It was enacted as part of the Tax Reform Act of 1969 in response to revelations that 155 taxpayers with

\textsuperscript{15}For example, the National Conference of State Legislatures reports that several states have adopted income tax credits for donations to qualifying school tuition organizations (STOs). Those include programs with credit percentages ranging from 50 to 100 percent (see NCSL, “Tuition Tax Credits: Overview”). The availability of those tax credits for donations to tuition organizations in Arizona was the subject of Arizona Christian School Tuition Organization v. Winn, 131 S. Ct. 1436 (2011).

\textsuperscript{16}In Arizona Christian, 131 S. Ct. 1436, Justice Anthony Kennedy said, “When Arizona taxpayers choose to contribute to STOs, they spend their own money, not money the State has collected from respondents or from other taxpayers” (emphasis added). That conclusion is relevant to whether the parties challenging the constitutionality of the Arizona statute on establishment clause grounds had standing to pursue the lawsuit. For an opposing perspective noting the fundamental interchangeability between government expenditures and tax credits, see Justice Elena Kagan’s dissenting opinion in the case.

\textsuperscript{17}Section 164.

\textsuperscript{18}Even outside the AMT context, taxpayers should generally prefer deductible charitable contributions to nondeductible state and local taxes, such as retail sales taxes or gas taxes, suggesting that a tax credit scheme aimed at converting state sales or gas tax liability to charitable contributions would be subject to the same type of analysis described in the text. Tax credits are far less common in those contexts than in the income tax context.
Section 55(b)(1)(A)(i).

Thus, as is true with AGIs exceeding $200,000, and three-quarters were filed by taxpayers with adjusted gross incomes exceeding $100,000, and three-quarters were filed by taxpayers with adjusted gross incomes exceeding $200,000. Nearly all those returns (96 percent) were filed by taxpayers with AGIs exceeding $100,000, and three-quarters were filed by taxpayers with adjusted gross incomes exceeding $200,000. Approximately 4.5 percent of federal income tax returns featuring AMT liability are California, Connecticut, Maryland, Massachusetts, New Jersey, and New York.

C. California AMT Data

IRS data reveal more detail about the operation of the AMT in California. For tax year 2010, approximately 4.5 percent of federal income tax returns filed in California showed some AMT liability. Nearly all those returns (96 percent) were filed by taxpayers with adjusted gross incomes exceeding $100,000, and three-quarters were filed by taxpayers with AGIs exceeding $200,000. Thus, as is true throughout the country, AMT liability of Californians is concentrated in the top decile of the income distribution. For those taxpayers, an increase in their state tax liability will have no effect on their federal income tax liability because of the nondeductibility of state and local taxes under the AMT. However, an increase in charitable contributions would reduce their federal income tax liability by the amount of the contribution multiplied by the marginal tax rate, which for those subject to the AMT would be either 26 or 28 percent.

III. Effects of a State Charitable Tax Credit

The differential treatment of state and local taxes and charitable contributions under the AMT creates an opportunity for tax planning. The tax planning we have in mind is not the conventional variety, in which an individual or business entity engages the expertise of a tax lawyer or accountant with an eye toward minimizing its tax obligations. Rather, what we envision is state legislation enacted specifically for the purpose of exploiting the federal tax code’s differential treatment of those two types of payments.

We offer our analysis merely as a thought experiment in the hopes of revealing the intuition underlying the idea. Our aim is not to endorse a California state charitable tax credit — indeed, we have some doubts about its viability as a means of capturing additional federal resources for the state. Rather, we will highlight the technical legal questions that would need to be answered to ensure that such a credit would have the desired effects.

A. (Potential) Federal Tax Benefits

The potential benefit of a state income tax credit for charitable contributions is best understood with an extreme example — that is, a 100 percent California state income tax credit for donations to a California state charitable contribution fund (CSCCF) — which we will refer to as Example A. Assume the purpose of the fund will be to undertake some sort of activity that has the effect of defraying state general fund expenditures. Taxpayer Joe, who has federal AGI between $400,000 and $500,000 and is subject to the federal AMT, plans to contribute $10,000 to the fund.

If respected as a charitable gift, the contribution will entitle Joe to a $10,000 income tax credit on his California state income tax return and a $10,000 charitable contribution deduction on his federal income tax return. The $10,000 California state income tax credit fully compensates Joe for the contribution. Thus, while his state income tax liability has decreased by $10,000, his total payment to the state has not changed; it’s just that $10,000 is directed to the CSCCF instead of to the state’s general fund. From the state’s perspective, that should be simply an accounting maneuver, at least insofar as CSCCF resources are used to defray general fund expenditures.

---

20Tax Policy Center, “Reconciling AMTI and Taxable Income for AMT Taxpayers” (Dec. 21, 2010) (deduction for state/local taxes accounted for more than 68 percent of AMT adjustments and preferences for 2008).
21IRS Statistics of Income, “Historic Table 2” (2010).
22See Emmanuel Saez, “Striking It Richer: The Evolution of Top Incomes in the United States” (updated with 2009 and 2010 estimates), Figure 2 (Mar. 2, 2012) (noting that the breakpoint for the top decile, based on national figures, was $108,000 in 2010).
23Section 55(b)(1)(A)(i).
By contrast, the effect on Joe's federal income tax liability is more meaningful. While the $10,000 reduction in Joe's state income tax payments has no effect (because he is subject to the AMT and thus enjoys no benefit from state and local tax deductions), his charitable contribution deduction has increased by $10,000. At a marginal tax rate of 28 percent, Joe should see a reduction in his federal income tax liability of $2,800. Thus, merely by relabeling the $10,000 (from "tax" to "gift"), Joe saves $2,800 in federal taxes.\(^\text{24}\)

California may wish to adopt such a scheme solely for the benefit of taxpayers like Joe, or it may decide to offer a state income tax credit for some amount less than 100 percent in an effort to capture some portion of that $2,800 for public expenditures or other purposes. For example, let's modify our hypothetical slightly (Example B) and assume that the state income tax credit is 80 percent instead of 100 percent. Under that scenario, Joe's contribution of $10,000 would reduce his state income tax liability by only $8,000, with the result that his net payments to the state have increased by $2,000 as a result of his gift to the fund. However, the federal tax treatment of the transfer would remain the same — that is, his federal income tax liability would be reduced by $2,800 by virtue of the increase in his deductible charitable contributions by $10,000. In effect, when the state income tax credit is less than 100 percent, the state is able to claim a share of the federal tax savings arising from the transfer.

At this point, the reader is likely thinking (or, if not, perhaps should be), "This can't work." After all, the state income tax credit scheme described has all the markings of a transparent tax avoidance scheme — that is, mere paper shuffling and relabeling devised to reduce federal tax liabilities. That a state government is initiating the scheme does not make it any less objectionable on the grounds of substance over form or other judicial antiavoidance doctrines. The right answer seems to be that the taxpayer's charitable contribution deduction should be reduced by the value of the state tax benefit arising from the transfer. Thus, in Example A, Joe's charitable contribution deduction for the $10,000 transfer to the CSCCF should be zero. In Example B, the allowable charitable contribution deduction should be $2,000. In both cases, to allow a charitable contribution deduction of $10,000 on the federal return is to ignore the significant state tax benefit arising from the income tax credit. That result seems to follow from the Treasury regulations discussed.

Despite seeing those answers as "correct," we see two problems. First, the IRS has recently taken a contrary view, concluding that a state or local tax benefit, for example, a state income tax credit for donations of cash or property to a state agency, "is treated for federal tax purposes as a reduction or potential reduction in tax liability" and not as consideration that might constitute a quid pro quo for purposes of section 170. Second, for the IRS to rule otherwise likely would require a broader reconsideration of the long-standing principle that "the tax benefit of a federal or state charitable contribution deduction is not regarded as a return benefit that negates charitable intent, reducing or eliminating the deduction itself." Those passages are from the chief counsel's office 2010 memorandum on this issue.

\section*{B. ILM 201105010}

In early 2011 the IRS Office of Chief Counsel released a memorandum it had prepared in October 2010 regarding the deductibility of donations that entitle the taxpayer to a state-level tax credit.\(^\text{25}\) The memorandum considered whether a taxpayer's contribution of cash or other property to a state agency should be considered a charitable deduction under section 170 or payment of a state tax under section 164 when the taxpayer receives a state income tax credit in lieu of a state charitable contribution deduction for the payment.

The facts considered in the chief counsel's office analysis can be summarized as follows. Over the course of two years, the taxpayers contributed cash and appreciated property to some qualifying organizations under the terms of four tax credit programs adopted by State X. Under the law of State X, the tax credits could be used to reduce the taxpayers' state income tax liability in the year of the contribution, carried forward to the following year if unused in the year of the contribution, or sold to other taxpayers who would use the credits to reduce their state income tax liability.

In year 1, the taxpayers submitted applications to the State Department of Economic Development.

\footnote{A comparable benefit arises when a taxpayer makes a federally deductible donation and is granted a state credit for some state or local tax that is not deductible for purposes of the federal income tax. That would be the case, for example, for a retail sales tax credit or a gasoline tax credit. Except in the relatively rare case of a taxpayer electing to deduct sales taxes in lieu of income taxes, those taxes are generally not deductible for anyone. Thus, to the extent that a charitable contribution gives rise to a federal income tax deduction for the full amount of the gift and a state tax credit for one of those nondeductible taxes, the effect is to convert the payment of a nondeductible tax to a deductible gift.}

\footnote{While the memorandum can be viewed as the office's current position on the topic, it bears noting that the advice in the memorandum "may not be used or cited as precedent." ILM 201105010, supra note 4, at 1.}
and was granted a state tax credit equal to an unspecified percentage of the contributions. The taxpayers used a portion of those credits to reduce their year 1 state tax liability, sold another portion to other taxpayers, and carried forward the remaining credits to future tax years. In year 2, the taxpayers submitted applications to the state for additional contributions and claimed the resulting state tax credits, as well as the credits carried forward from year 1, to offset their year 2 state income tax liability.

The chief counsel’s analysis of the federal income tax consequences of those contributions is relatively brief and straightforward. To be deductible as a charitable contribution under section 170, “a transfer to a charitable organization or government unit must be a gift,” defined as “a transfer of money or property without receipt of adequate consideration, made with charitable intent,” according to the IRS. Moreover, a transfer will not be considered to have been made with charitable intent “if the transferor expects a direct or indirect return benefit commensurate with the amount of the transfer.” When the transferor receives some benefit in exchange for the contribution, “the transfer may be deductible as a charitable contribution, but only to the extent the amount transferred exceeds the fair market value of the benefit received, and only if the excess amount was transferred with the intent of making a gift.”

An obvious question arising from those principles is whether the federal or state tax benefits accruing to a taxpayer as a result of making a charitable gift should be regarded as a “benefit received” that might reduce or eliminate the charitable nature of the transfer. In a series of cases cited in the chief counsel memorandum, federal courts generally held that the “tax benefit of a federal or state charitable contribution deduction is not regarded as a return benefit that negates charitable intent, reducing or eliminating the deduction itself.” In many of those cases, the court’s conclusions are stated in very strong terms. For example, in McLennan, the U.S. Claims Court noted that “a donation of property for the exclusive purpose of receiving a tax deduction does not vitiate the charitable nature of the contribution.” Likewise, in Skripak, the Tax Court stated that “a taxpayer’s desire to avoid or eliminate taxes by contributing cash or property to charities cannot be used as a basis for disallowing the deduction for that charitable contribution.”

The central question addressed in the chief counsel memorandum is whether a tax credit should be treated any differently from a tax deduction in assessing whether the taxpayer has received a benefit that might reduce or eliminate the federal income tax deduction. Because deductions and credits have essentially identical effects — that is, reducing the donor’s income tax liability by some amount — it is hard to see why one would ignore the tax benefits associated with deductions while taking into account any tax savings arising from tax credits. It is possible that the value of a deduction (which depends on the taxpayer’s marginal tax rate) and the value of a tax credit (which depends on the statutory credit percentage) may differ, but there is no reason to assume that either one will be systematically higher or lower than the other.

Perhaps in recognition of the fundamental interchangeability of credits and deductions, the IRS refused to apply a different rule for tax credits than the one that already applies for tax deductions, concluding that it saw no reason “to distinguish between the value of a state tax deduction, and the value of a state tax credit, or to draw a bright-line distinction based on the amount of the tax benefit in question.” That language seems to suggest that the same treatment accorded to a tax deduction when the taxpayer’s marginal state income tax rate is 10 percent would be extended when the taxpayer claims a state income tax credit, regardless of the statutory credit percentage. Significantly, however, the memorandum also states 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.”

In our view, the language just quoted likely represents an implicit recognition of the potential federal tax benefits to AMT payers from claiming especially “generous” state tax credits for charitable contributions. To be sure, those benefits arise from the use of less generous state tax credits, as well as tax deductions. Indeed, any payment that reduces an AMT payer’s state income tax liability while increasing her charitable contribution deductions converts nondeductible taxes to deductible gifts to the extent of the reduction in state tax liability. In most cases, however, the magnitude of the federal tax benefit is relatively insignificant. For example, for deductions for state charitable contributions, the benefit is unlikely to exceed one-tenth of the

---


27 McLennan, 23 Cl. Ct. 99.

28 Skripak, 84 T.C. at 319.
amount of the gift because state income tax rates rarely exceed 10 percent.\(^29\)

When a state income tax credit features a higher credit percentage, the federal tax benefit is correspondingly greater. Again, the benefit to the taxpayer is greatest when the state allows a 100 percent income tax credit, fully compensating the taxpayer for the cost of her “gift.” State tax credits featuring a lower percentage are naturally less attractive to the taxpayer but could generate resources for the state.

C. Transferable Tax Credits Under Tempel

Until now, we have been assuming a program in which the state income tax credit may be used only by the taxpayer making the initial contribution giving rise to the credit. It is possible, however, that the state will permit those credits to be sold by the original claimant and transferred to a taxpayer better positioned to make use of them. That was precisely the type of statute that the taxpayers took advantage of in Tempel v. Commissioner.\(^30\) The Tempel case illustrates a further benefit that might be derived from the adoption of a state charitable tax credit.\(^31\)

In December 2004 Colorado residents George and Georgette Tempel donated conservation easements to the Greenlands Reserve, a nonprofit organization formed to promote environmental protection and open space through the acquisition of negative easements limiting development on the donated property. To encourage the transfer of easements to those types of organizations, Colorado granted donors a state income tax credit equal to 100 percent of the first $100,000 of the value of the easement, plus 40 percent of the value of the easement exceeding $100,000. In no event could the credit exceed $260,000, and it could be used by the donors to reduce their Colorado state income tax liability (and sometimes generate refunds), or it could be transferred, with or without consideration, to other taxpayers who could use the state income tax credits to reduce their Colorado state income tax liability (but not to generate a refund).

Based on an $836,500 value of the easements, the Tempels received state income tax credits of $260,000, the maximum credit allowable under the Colorado statute. It appears that they used most of the credits to reduce their own state income tax liability. Consistent with ILM 201105010, the IRS contended, and the taxpayers agreed, that their “receipt of State tax credits as a result of their conservation easement contribution was [not] a quid pro quo transaction.” The Tax Court accepted that. Because that issue was not in dispute, the court’s acceptance of the parties’ stipulation should not be regarded as an element of the holding in the case. The court’s acceptance, along with its own citation to ILM 201105010, reinforces the view that a taxpayer receiving a state charitable tax credit need not reduce the amount of the charitable contribution deduction by the value of the credit.

The central issue in Tempel was the proper federal income tax treatment of the taxpayers’ transfer on December 22, 2004, of $40,500 of the state income tax credits for $30,375. The taxpayers took the position that the sale gave rise to long-term capital gain, while the IRS contended that the taxpayers realized ordinary income from the sale. After a lengthy analysis, the court concluded that the taxpayers had short-term capital gain from the sale of the credits in 2004. It also determined that the taxpayers had a zero basis in the credits, with the result that they experienced a gain of $30,375 from the December 2004 sale.

At first blush, the holding seems to split the difference between the competing positions advanced by the taxpayers and the IRS. After all, short-term capital gain is generally taxed at the same rate as ordinary income, suggesting that while the Tax Court rejected the government’s position, the de facto result was equivalent to a government victory. Nevertheless, the Tempel holding is remarkable because it suggests that if the taxpayers had simply held the credits for more than one year they would have recognized long-term capital gain from their sale. In combination with the chief counsel’s office position that a taxpayer need not reduce her charitable contribution deduction by the value of the state tax benefits generated by the donation, Tempel appears to give donors the ability to convert ordinary income (taxed at a maximum statutory rate of 39.6 percent) to long-term capital gain (typically taxed at 20 percent).\(^32\)

\(^29\)For example, in a state that follows federal law in allowing charitable contribution deductions, a $10,000 gift to charity would, assuming a 10 percent state income tax rate, reduce the donor’s state income tax liability by $1,000 — in effect shifting $1,000 of nondeductible taxes to $1,000 of deductible donations.

\(^30\)Tempel, 136 T.C. 341.


\(^32\)Section 1(a) and (b). Even if the taxpayer fails to satisfy the holding period to qualify the gain from a sale of the credits as long-term capital gain, short-term capital gain can be preferable to ordinary income in that it can absorb capital losses without limit (whereas capital losses can only offset ordinary income up to $3,000 per year). Thus, converting ordinary income to short-term capital gain may be beneficial to taxpayers with significant capital loss carryovers from previous years.
To illustrate, assume for the sake of analysis that the taxpayers in Tempel contributed a conservation easement worth $100,000 to Greenlands Reserve. Assume further that rather than use any of that credit to reduce their own state income tax liability, the Tempels instead sell the full $100,000 worth of credits for $100,000 after the requisite holding period. Taxes aside, they have experienced no increase or decrease in wealth, having parted with property worth $100,000 but receiving $100,000 cash. Note, however, that while the $100,000 “donation” will reduce the Tempels’ federal income tax liability by as much as $39,600 (that is, $100,000 multiplied by the top marginal tax rate of 39.6 percent), the $100,000 gain from the sale of the credits increases their federal income tax liability by only $20,000 (that is, $100,000 of long-term capital gain multiplied by the maximum rate on net capital gain of 20 percent). In effect, the donation permitted them to convert $100,000 of their ordinary income (via the charitable contribution deduction) to long-term capital gain.

By treating the sale of state charitable tax credits as the sale of a capital asset while also allowing a full deduction for gifts without reduction for the state tax benefits generated by the contribution, Tempel effectively empowers state governments to issue “capital gains coupons” in the form of transferable state charitable tax credits. That outcome expands the population of taxpayers who could benefit from the adoption of a state charitable tax credit beyond just those taxpayers subject to the AMT. Any itemizing taxpayer subject to a marginal tax rate on ordinary income greater than the capital gains tax rate could benefit by making a gift that generates a transferable state charitable tax credit, claiming the full federal deduction for the gift, then later selling the credit at the lower capital gains rate.33

To illustrate the effects of that transaction, assume that taxpayer Dan makes a $100,000 donation to a California state agency and in exchange for that gift receives a $100,000 state charitable tax credit, which may be used to reduce his own state income tax liability or may be transferred to a third party for use in satisfying that person’s state income tax liability. Under the logic of ILM 201105010, Dan should be entitled to a federal charitable contribution deduction of $100,000, which should have the effect of reducing his federal income tax liability by as much as $39,600 (that is, $100,000 multiplied by the top marginal rate of 39.6 percent). If Dan is an itemizing taxpayer not subject to the federal AMT, using the credit to satisfy his own state income tax liability will have the dual effect of increasing his charitable contribution deduction by $100,000, and reducing his state and local tax deduction by $100,000. In other words, it’s a wash for Dan.

However, if Dan sells his $100,000 hypothetical California state income tax credit to Boris, he will deduct $100,000 as a charitable contribution deduction under the logic of ILM 201105010 and recognize $100,000 of gain from the sale of the credits under Tempel. Assuming Dan holds the credits for a year before making the sale to Boris, the $100,000 gain should be taxed as long-term capital gain, most likely subject to the maximum statutory rate of 20 percent. Thus, the net benefit of the transaction is $19,600 to Dan (that is, $39,600 less $20,000). Meanwhile, Boris should be indifferent to paying $100,000 to Dan or to the state because, according to the IRS, “a purchaser of transferable Credits will be allowed a deduction under section 164 for State X income taxes paid with the purchased Credits.”34

As with the nontransferable charitable tax credit described above, the state may decide to capture some portion of the tax savings by specifying a credit percentage less than 100 percent. For example, assume that the credit percentage is 90 percent and Dan again makes a donation of $100,000. With the lower credit percentage, Dan will be entitled to a tax credit of $90,000. If he later sells the credits to Boris for $90,000 (after the one-year holding period for long-term capital gains), he will deduct $100,000 as a charitable contribution deduction in year 1 (tax savings of $39,600 based on a 39.6 percent tax rate), and recognize $90,000 of long-term capital gain in year 2 (tax of $18,000 based on a 20 percent rate). Here, the net benefit from the federal government is $21,600 but it is divided between Dan ($11,600) and the state government ($10,000).35

There are numerous variations on those hypotheticals that could illustrate the effects in slightly different circumstances, involving taxpayers subject

---

33It is worth noting that while a payment by a purchaser of state tax credits “is clearly not a payment of tax or a payment in lieu of tax” that would be deductible under section 164, the IRS appears to accept as a deductible tax payment the use of the credit as a means of satisfying the credit purchaser’s state tax liability, analogizing the use of the credit to a transfer of property by the taxpayer in satisfaction of her tax liability. See LTR 200348002.

34Id.

35In effect, Dan has converted $90,000 of ordinary income into long-term capital gain, reducing the tax on that $90,000 of income by 19.6 percentage points (39.6 to 20 percent) for a tax savings of $17,640, and he is also getting the benefit of tax savings at the rate of 39.6 percent for the $10,000 “real” gift for a tax savings of $3,960. So Dan parts with $10,000 (net payment to state) but gains $21,600 in federal tax savings for a net benefit to Dan of $11,600 and a net benefit to the state of $10,000.
to higher or lower marginal tax rates, state credits for taxes other than income taxes, credits that could be used by businesses to offset their tax liability, and so on. While each of those situations presents slightly different tax implications, the core tax advantage in each case arises from the possibility that a taxpayer who transfers $X to a qualified entity, including a state agency, is entitled to deduct $X as a charitable contribution on her federal return even though she receives a state tax benefit — perhaps even a benefit equal to $X — as a result of making the gift.

IV. Tax Credit for Donations to Cal Grants

We have left unspecified the types of public programs that could benefit from a state charitable tax credit program. As noted in Section II, the only requirement of federal law concerning contributions to state agencies is that “the contribution or gift [be] made for exclusively public purposes.” Thus, it would appear that states such as California have wide latitude in designing charitable tax credits.

For purposes of illustration, we will consider how such a program might work in the context of public higher education. De León recently introduced legislation to promote charitable contributions to fund an expansion of coverage under the Cal Grants program — the state’s principal means of providing financial support for low- and middle-income students to pursue postsecondary education. The discussion that follows uses the de León legislation as a platform for considering how the state might take advantage of ILM 2011010050, the federal AMT’s differential treatment of charitable contributions and state/local taxes, and the Tax Court’s decision in Tempel.

A. The College Access Tax Credit

In February 2013 de León introduced S.B. 284, legislation that would have established a college access tax credit program (CATCF) special fund, designed to provide new funding for Cal Grants. One rationale underlying S.B. 284 was the significant reduction in state support for higher education over the past quarter-century. A recent analysis suggests that per-student funding for public higher education in California declined by 46 percent between 1990 and 2012. In absolute dollar terms, California has reduced funding for public postsecondary institutions by $1.4 billion between 2006 and 2012. S.B. 284 appears to have been motivated by a desire to temper those effects by increasing funds available for middle-income households hoping to pursue postsecondary education.

The CATCF aimed to accomplish that using a state-level tax credit for taxpayers that make donations to the program. The language of the bill as proposed awarded a 60 percent state tax credit for donations to the CATCF in 2014. The tax credit was to be reduced by 50 percent in both 2015 and 2016, after which point the program would end. The program fund was capped at $500 million annually.

Applying the analysis discussed above in Section III, a gift to the CATCF would generate two significant tax benefits for the donor. First, the taxpayer would be entitled to a state income tax credit for 60 percent of the amount of the gift (assuming a gift in 2014). Second, applying the logic of ILM 201105010, the taxpayer would be entitled to claim a charitable contribution deduction on her federal income tax return for the full amount of the gift.

To illustrate, assume that Elena makes a qualifying gift to the CATCF of $100,000, which under S.B. 284 would entitle her to a California state income tax credit of $60,000. Assuming for the moment that Elena is not subject to the federal AMT, her gift should (1) entitle her to a charitable contribution deduction of $100,000 on her federal income tax return, and (2) reduce her California state income tax liability by $60,000, which will (3) reduce her federal deduction for state/local taxes by $60,000. The net effect is that Elena’s payments to California increase by $40,000 and her overall federal deductions increase by $40,000. We will refer to the $40,000 figure as the “true gift” portion of her total payment to the state and the $60,000 portion as a “faux gift” because it is effectively refunded to her through the state tax credit. Elena’s federal income tax burden drops by $15,840, which is simply the $40,000 true gift portion of her donation multiplied by the top rate of 39.6 percent. Note that this result is no different from the benefit Elena would receive by making a charitable donation of $40,000 to the state of California.

[40]Id. at section 1(a)(1)(B).
[41]Id. at section 1(b)(1).
Algebraically, the net after-tax cost of the gift to Elena can be stated as:

\[(1) \ G(1 - f)(1 - s)\]

or

\[(2) \ G(1 - f - s + fs)\]

where \(G\) is the gross amount of the gift, \(f\) is the federal marginal tax rate, and \(s\) is the state credit percentage. Assuming a federal rate of 39.6 percent and applying the CATCF credit percentage of 60 percent, the after-tax cost of a $100,000 gift is 

\[\$100,000 \times (1-0.396)(1-0.6)\]

$24,160. Intuitively, that can be described as a combination of: (1) a gross cash outflow of $100,000; (2) minus $39,600 in federal tax savings from the federal charitable contribution deduction of $100,000; (3) minus $60,000 in state tax savings from the state charitable tax credit at a 60 percent credit percentage; (4) plus $23,760 in increased federal taxes arising from the $60,000 reduction in the federal deduction for state and local taxes.

The key is that even though Elena is saving $39,600 in federal taxes by virtue of her $100,000 charitable contribution deduction, she is also increasing her federal tax payments by $23,760 by virtue of losing $60,000 in deductions for state and local taxes. In effect, because Elena loses $60,000 worth of California state and local tax deductions on her federal return, she ends up deducting only the true gift portion of her donation. The faux gift portion is effectively rendered nondeductible by the $60,000 reduction in the deduction for state and local taxes.

If Elena is subject to the federal AMT, the $100,000 gift to the CATCF will entitle her to a charitable contribution deduction of $100,000 on her federal income tax return and reduce her state income tax liability by $60,000. Significantly, however, the reduction in state income tax liability in that scenario has no effect on Elena’s state and local tax deduction because state and local taxes are not deductible for AMT payers. The result is that Elena deducts not only the $40,000 true gift portion of her donation (saving her $11,200 in federal income taxes) but also the $60,000 faux gift portion (saving her $16,800 in federal income taxes). As a result, her total federal tax savings will be $28,000 — that is, $100,000 gross gift multiplied by a marginal tax rate of 28 percent (the top rate for AMT payers).

Algebraically, the net after-tax cost of the gift to Elena when subject to the AMT can be stated as:

\[(3) \ G(1 - f - s)\]

which differs from equation (2) above in that it does not feature the “+ fs” term that represents the federal tax increase attributable to the loss of state and local tax deductions that an itemizing taxpayer would normally experience as a consequence of a reduced state income tax burden. But recall that in the non-AMT example it was the loss of state and local deductions that effectively rendered the faux gift portion of the donation nondeductible. Because an AMT payer has no state and local tax deductions to lose, there is no mechanism by which her federal deductions are effectively limited to the true gift portion of the donation.

Based on that analysis, we can see that an AMT payer making a $100,000 donation to the CATCF special fund has a net out-of-pocket cost of only $12,000 — that is, $100,000 minus $28,000 (in federal tax savings) minus $60,000 (in state tax savings). Clearly, the tax savings for that type of donation are far more than the tax savings normally arising from charitable gifts. AMT payers willing to make a gross gift of $1 to Cal Grants will be reimbursed a total of $0.88, consisting of $0.60 from the state of California and $0.28 from the federal governments.

As structured, S.B. 284 is a powerful “matching grant” program that if enacted is likely to generate significant new funds for the Cal Grants program. Indeed, the matching rates are so generous that it is also likely to draw charitable dollars away from other worthy causes. Even so, it is worth noting that the program could be made even more attractive to potential donors. The most obvious way to do that would be to increase the credit percentage. Any credit percentage greater than 72 percent would ensure that donors experience no out-of-pocket costs for their donations. In states with charitable tax credit programs already in place, tax planners are beginning to catch on. One website describing Arizona’s tax credit for school tuition organizations notes that if you are subject to the AMT, the tax benefits received exceed the out-of-pocket cost.\(^{42}\)

B. Expanding the (Potential) Benefits of S.B. 284

The two examples just described — one involving an itemizing taxpayer not subject to the AMT and the other featuring a taxpayer subject to the AMT — reveal that a state income tax credit of the sort incorporated in S.B. 284 is likely to be most attractive to taxpayers subject to the AMT, which includes roughly 750,000 federal tax returns filed from California in 2010. Yet the potential benefit of a CATCF need not be limited to AMT payers. Building from the analysis in Section III, we note two possible changes to the CATCF framework that could expand the reach of its benefits.

First, to the extent that the tax credit is transferable, the Tax Court’s decision in Tempel suggests

\(^{42}\)George Woodard, “Expansion of Private School Tuition Tax Credit Program” (May 8, 2012).
that a sale of the credit will give rise to capital gains rather than ordinary income. As a result, a taxpayer not subject to the AMT actually would be better off selling the credit (after holding it for more than a year to qualify for long-term capital gains) instead of using it herself. As noted above, using the credit results in a lower federal deduction for state and local taxes — that is, the “+ fs” term in equation (2). By selling the credit after a year, the taxpayer experiences a different and smaller federal tax increase (that can be portrayed by replacing the “+ ks” term in equation (2) with “+ ks” where k is the federal capital gains rate) than if she uses the credit herself.

As an example, assume that Peter donates $100,000 to the CATCF fund, which entitles him to a $60,000 credit that he sells 13 months later for $58,000. Under the logic of ILM 201105010, he should be able to claim a deduction of $100,000 for the donation, which assuming a federal tax rate of 39.6 percent saves him $39,600 in federal income taxes. The subsequent sale of the credit for $58,000 (zero basis) generates a tax of $11,600 ($58,000 x 20 percent). Thus, while Peter experiences an initial cash outlay of $100,000, he recoups $86,000 from federal tax savings and the later sale of the credits to a third party.

Second, the benefit of the CATCF could be expanded by providing a credit against taxes other than the state income tax. For example, if the state were to grant a 60 percent sales tax credit instead of an income tax credit, such a program would likely be attractive to AMT payers and even more so to high-bracket itemizing taxpayers not subject to the AMT. That is because sales taxes are generally not deductible for purposes of the federal income tax.

For example, if Lakshmi were to donate $100,000 and therefore qualify for a $60,000 sales tax credit, she would be able to claim a $100,000 charitable contribution deduction under the logic of ILM 201105010 and reduce her state sales tax payments by $60,000. Although sales tax credits are far less common than income tax credits, they are not unheard of. Perhaps the sales tax credit could take the form of a debit card that the taxpayer could use to make sales tax payments when making taxable purchases.

Lakshmi’s reduction in state sales tax liability should have no effect on her federal income tax liability because sales taxes are generally not deductible. But note that she is effectively making sales taxes deductible by smuggling them into her $100,000 charitable contribution deduction. As a result of her $100,000 gift, Lakshmi’s federal income tax burden should be reduced by $39,600 (assuming a 39.6 percent federal tax rate). In form, Lakshmi is donating $100,000 to a good cause. In substance, one might say that she is donating $40,000 to a good cause and purchasing a $60,000 prepaid sales tax debit card. Because of ILM 201105010, both amounts appear as deductions on her federal income tax return in the form of a $100,000 charitable gift, saving her $39,600 in federal income taxes.

As with our other examples, the benefit can be made even more generous by increasing the credit percentage. For example, if we assume a state sales tax credit of 75 percent for donations to a state agency, anyone subject to a federal marginal tax rate greater than 25 percent, whether subject to the AMT or not, would actually profit by making a gift to the state agency. We hasten to emphasize that this “profit” comes at the expense of the federal treasury and thus has more in common with the gains enjoyed by Bonnie and Clyde than by a small business owner or productive entrepreneur. Still, given the IRS’s position in ILM 201105010, it is understandable why a state may wish to partner with its taxpayers to promote charitable gifts to state agencies.

V. Conclusion

The opportunities for California to make its tax code more efficient from a state perspective might well be considered bad policy from a national viewpoint. If we were advising Congress, we might suggest that those opportunities result from flaws at the national level. However, members of the State Legislature are custodians of state welfare, particularly in an era of state budgetary distress. Thus, it behooves the Legislature at least to investigate potential adjustments to California state tax arrangements that would benefit the state by bringing in more federal dollars.