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Table of Contents

Preface

California Policy Options is an annual collection of research and insight on issues and challenges facing the State produced by the UCLA Luskin School of Public Affairs and our Ralph and Goldy Lewis Center, which advances research solutions for California's urban and regional challenges, with an emphasis on transportation, economic development and housing, and the environment.

Each year, Professor Daniel J.B. Mitchell collects and edits a collection of new California-focused articles by Luskin and Lewis Center center-affiliated UCLA faculty and graduate students. The volume becomes the reader for an always lively and current undergraduate class on California policy issues taught each winter quarter by Professors Mitchell and Michael Dukakis. It is distributed to libraries and made available on School and academic websites for researchers, journalists, and citizens. Professor Mitchell also contributes a seminal analysis of the state's budget processes and details.

California Policy Options exemplifies many of the values and goals of the UCLA Luskin School of Public Affairs and the Lewis Center. It works across academic boundaries. It covers a wide range of issues. And it provides dispassionate empirical analysis from both the macro and micro view of pressing public policy problems important to us all.

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Dean
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Introduction

Our annual *California Policy Options* volume for 2013 devotes half its attention on matters relating to taxes and state fiscal policy; four of our eight chapters deal with those matters. Perhaps that emphasis is not surprising given the fiscal focus at the state level in the November 2012 general election. Three of the November ballot propositions dealt with tax increases (and two passed). One proposition dealt with the process of state budgeting (and didn't pass). Apart from our fiscal focus in this edition, we continue our past practice of highlighting student research on California policy in the Luskin School of Public Affairs. Three of our chapters are based on student research projects.

Our volume begins with a chapter on a tax credit given by the state in 2009 to encourage local film and TV production. As Lauren Appelbaum, Chris Tilly, and Juliet Huang note, other states and countries have encouraged what some call "runaway" production (production outside California) by giving various tax credits to producers. The authors find that these credits do have the effect of drawing production away from California. Runaway production could have a cumulative effect as the out-of-state locations build up local industry infrastructure and workforce skills. They also find that the benefits of the California tax credit modestly exceed its cost.

Phillip Blackman and Kirk Stark note that given California's ongoing state budget crisis, any federal dollars that can be brought in would provide some fiscal relief. They find an oddity in federal tax law related to charitable contributions and other aspects of the U.S. tax code that could attract federal dollars. Blackman and Stark do not argue that the oddity is good national public policy. But they note that since the potential exists for a benefit to the state, legislators should at least investigate this opportunity.

Jenna Chilingerian notes the growth over time in a public policy interest in California in preserving historic structures. Many such structures are in private hands, however, and private owners do not necessarily have the same interest. Nonetheless, incentives, such as reduced property tax rates, can change the calculus for such owners and have been offered in California. Chilingerian notes that California could go further in offering preservation inducements to property owners but before making such a commitment, she suggests that the state conduct a survey to determine what benefits might accrue.

In his chapter, Daniel Mitchell continues his history of California's budget story that has appeared in prior editions of *California Policy Options*. This time the history extends through the close of the legislative session in August 2012. By that point, through the initiative mechanism, the governor had placed a tax proposition (Prop 30) on the ballot, sold as a remedy for the ongoing budget crisis. His use of the initiative approach resulted from the prior year's ill-fated attempt to garner enough votes in the legislature to place a similar proposition on the ballot. We know, with hindsight not available when the chapter was written, that in fact the governor's initiative passed, a story that awaits future editions of this volume.

In many ways, California's economy depends on its infrastructure. Of course, infrastructure has direct costs related to construction. But there are also ongoing costs, including potential negative "externalities." The twin ports of Los Angeles and Long Beach are by far that largest seaport complex in the U.S. But internationally traded products that go through the ports must arrive and depart through land transportation. Both ports have developed clean trucks programs designed to reduce air pollution. Under these programs, old trucks are being removed from service and replaced by lower-polluting vehicles. In his chapter, Zachary Rehm finds that the programs of the ports, which essentially subsidize the truck replacements, have been effective in producing a significant air pollution reduction.

After the 2001 terrorist attacks on the U.S., the L.A.-Long Beach port complex was seen as possessing another negative externality: the potential attraction of such an attack on the ports, possibly using a "dirty bomb." In addition, such an attack would close the ports and halt the large volume of trade passing through them with important negative impacts on the economy. In the 2005 edition of *California Policy Options*, a chapter by Zegart, Hipp, and Jacobson found notable deficiencies in the homeland security protections that had been developed up to that point for the two ports. William Sholan, in his chapter in the current edition, investigates whether the security umbrella has improved since 2005 and finds that it has. Security cannot be 100% effective but there has been a notable increase in funding and in coordination among the various agencies responsible for port protection.

As we look ahead, the state's economy remains a major concern. California was hard hit by the Great Recession and its recovery – while steady – has not been fast enough to bring the unemployment rate down to its pre-recession level. Jordan Levine and Christopher Thornberg of Beacon Economics find that the state's recovery can be expected to continue, even if at a modest pace. The fundamentals factors underlying a recovery appear to be in place and seem unlikely to be derailed.

Finally, William Parent looks at the political outlook for California through the lens of the state's new-old governor Jerry Brown. Brown is the second governor in the state's history to be elected to three terms (after Earl Warren) and, given term limits, will be the last. He succeeded in inducing voters to enact Prop 30 in 2012 and his party now holds a two-thirds margin in the legislature. However, Brown faces challenges, even with Prop 30 in place, regarding the budget. Moreover, there are other issues facing the governor such as his goal of high-speed rail construction and other infrastructure development. Finally, Parent suggests that given the two-thirds margin of Democrats in the legislature, Brown will be facing bold proposals for tax and governance reform from his party and will have to decide his own position on such matters.

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CHAPTER 2

Too Good to be True? How State Charitable Tax Credits Could Increase Federal Funding for California

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

—from the "Bucks" blog, *New York Times*, December 22, 2010

I. Introduction

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 these sentiments during his gubernatorial campaign in 2003, Arnold Schwarzenegger announced, "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 these 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.

Yet not all policies directing additional federal support to the state require Congressional approval. This chapter considers a legislative strategy for increasing federal funds that California could enact on its own initiative—i.e., 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 effectively enable taxpayers to convert state income tax payments to charitable contributions on their federal income tax returns. This result would reduce the federal income tax liability of taxpayers subject to the federal alternative minimum tax (AMT), which disallows deductions for state and local taxes but permits them for charitable contributions. In addition, if the state were to adopt a transferable charitable tax credit, it

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[1] Public Policy Institute of California, Californians and their Government (http://www.ppic.org/content/pubs/survey/s_110mbs.pdf).

[2] See, e.g., Warren Olney, *Can the Terminator Be the Collectinator, Too?* KCRW, Which Way, LA? (February 16, 2005).

[3] Anthony York, *Campaign Notebook: Brown Goes Negative, Whitman Goes Big*, Capital Weekly, September 16, 2010.

could give taxpayers the ability to 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 that the charitable tax credit does not fully compensate taxpayers for their donations.

While this outcome may sound too good to be true, recent legal guidance from the Office of Chief Counsel of the IRS appears to provide support for the 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 a deduction for the full amount of her charitable contribution to a state agency despite the fact that she received a state income tax credit for some (unspecified) percentage of that amount. A recent U.S. 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.[4] This 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 arguably at variance with other legal authority requiring taxpayers 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's memorandum on this issue. We also consider the significance of the Chief Counsel's analysis for SB 1356, draft legislation recently proposed by California State Senator Kevin de León that would permit an income tax credit for certain contributions to a Higher Education Investment Tax Credit Program Special Fund. The HEITC program offers a framework for considering how California might take advantage of the IRS 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 SB 1356. Nevertheless, given the IRS position, the HEITC program deserves careful consideration as a means for California to

[4] Tempel v. Commissioner, 136 T.C. No 15 (2011).

pursue fiscal "self-help" via creative tax planning. While we believe the HEITC 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 alternative minimum tax.

A. *Charitable Contributions*

Section 170 of the Internal Revenue Code allows a deduction for "any charitable contribution… payment of which is made within the taxable year."[5] Significantly, the statute goes on to define a charitable contribution as a "contribution or gift to or for the use of", [inter alia], "*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."[6] 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 such gifts.[7]

Like all charitable donations, gifts to state and local governments are subject to the general rules 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 set forth in Treasury Regulation

[5] 26 U.S.C. section 170(a).
[6] 26 U.S.C. section 170(c) (emphasis added).
[7] Of course, gifts to state colleges and universities (as well as public schools at the K-12 level) are not at all uncommon, though 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 Journal of Corporation Law 803 (1998).

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."[8] The term "goods and services" is then defined to include "cash, property, services, benefits, and privileges."[9]

This 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 fair market value of whatever is received in return. Accordingly, the regulations specify in the very next paragraph that any otherwise allowable charitable contribution deduction cannot exceed "the excess of (A) The amount of any cash and the fair market value of any property (other than cash) transferred by the taxpayer to an organization described in section 170(c); over (B) The fair market value of the goods or services the organization provides in return."[10]

This approach is no doubt familiar to anyone who has ever made a donation to organizations such as NPR or PBS during one of their pledge weeks. It is not uncommon for these (and other) organizations to provide donors with some item of value in exchange for their gift. For example, in exchange for a gift of $500, PBS might send a donor the complete DVD set of the Ken Burns documentary on the Civil War. If that DVD set has a fair market value of $100, the taxpayer's charitable contribution will be limited to $400—i.e., the excess of the amount contributed ($500) over the fair market value 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

[8] 26 C.F.R. §1.170A-1(h)(1).
[9] 26 C.F.R. §1.170A-1(f)(5).
[10] 26 C.F.R. §1.170A-1(h)(1).

gifts.[11] It is not uncommon for states with an income tax to follow the federal tax code in providing a deduction for charitable contributions. Thus, in the example just mentioned, 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 significantly lower than federal income tax rates. In addition, as will be discussed further below, the reduction of the taxpayer's state income tax liability has its own federal income tax consequences—i.e., reducing the amount of otherwise deductible state income tax payments.[12] However, matters are complicated somewhat—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 for the sake of analysis 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 have the effect of reducing Dora's state income tax liability by $400. Deductions and credits are merely two different ways of

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[11] An exception is Naomi E. Feldman & James R. Hines, Jr., *Tax Credits and Charitable Contributions in Michigan* (October 2003) (http://www.bus.umich.edu/otpr/WP2003-7.pdf).

[12] As discussed *infra*, the reduction in state tax liability arising from the state-level deduction can also *increase* the taxpayer's federal income tax liability to the extent that the taxpayer's state and local tax deductions are reduced by virtue of the reduction in state tax liability. In this situation, the after cost of the gift is equal to the gross gift multiplied by $(1 - f)(1 - s)$, where f is the federal marginal tax rate and s is the state marginal tax rate.

accomplishing the same result; however, credits give policymakers more flexibility insofar as the subsidy rate can be set independently of marginal tax rates.[13]

In recent years, some states have adopted state income tax credits with extraordinarily high credit percentages, including some with a 100 percent state income tax credit.[14] 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 for the moment 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 this statute, a $1,000 "gift" to PBS would enable Dora to 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.[15] Such a scheme raises some interesting questions about politics and democratic theory (e.g., 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 our analysis.

For our purposes, the point to emphasize is that a 100 percent state income tax credit has the dual effect of (1) increasing the taxpayer's charitable contributions by the amount

[13] William J. Turnier and Douglas G. Kelly, *The Economic Equivalence of Standard Tax Credits, Deductions and Exemptions*, 36 Florida Tax Review 1003 (1984). Some commentators prefer credits over deductions on the grounds of both efficiency and equity. *See, e.g.*, Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA Law Review 1389, 1429 (2004) (examining arguments for converting the deduction for state and local taxes to a flat-rate credit); *see also* Lily L. Batchelder, Fred Goldberg, Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 Stanford Law Review 23 (2006).

[14] For example, the National Conference of State Legislatures reports that several states have adopted income tax credits for donations to qualifying "school tuition organizations." These include programs with credit percentages ranging from 50-100 percent. (see NCSL, *Tuition Tax Credits: Overview*, http://www.ncsl.org/issues-research/educ/school-choice-scholarship-tax-credits.aspx). The availability of these tax credits for donations to STOs in Arizona was the subject of the U.S. Supreme Court's decision in Arizona Christian School Tuition Organization v. Winn, 563 U.S. __ (2011).

[15] In the Supreme Court decision cited in Footnote 14, *supra*, Justice Kennedy observes, "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). This conclusion is relevant to the question of 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 same case.

donated, and (2) 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. Where the donee is not a private organization, such as NPR, PBS or United Way, 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 to convert what would otherwise have been a $1,000 state income tax liability into a $1,000 charitable gift.

B. *The Deduction for State and Local Taxes & the Rise of the AMT*

Under section 164 of the Internal Revenue Code, taxpayers are allowed a deduction for state and local property taxes, income taxes and, in certain circumstances, retail sales taxes.[16] This longstanding provision of federal tax law should have the effect of negating 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 to 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 not have any meaningful federal income tax consequences.

Significantly, however, state income tax payments and charitable contributions are treated differently for purposes of the federal alternative minimum tax. Whereas charitable contributions are deductible for both the regular income tax and the alternative minimum tax, state and local taxes are deductible only for the regular income tax. More precisely, section 56(b)(1)(A)(ii) of the Internal Revenue Code 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 this provision, taxpayers subject to the AMT typically enjoy no federal income tax benefit from the deduction for state and local taxes. Thus, while a taxpayer subject

[16] 26 U.S.C. section 164.

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 taxpayer will generally 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.[17]

Until recently, the alternative minimum tax was a relatively insignificant feature of the U.S. fiscal structure. The AMT was originally enacted as part of the Tax Reform Act of 1969 in response to revelations that 155 taxpayers with income in excess of $200,000 had zero federal income tax liability in 1966.[18] Congress responded with the AMT to ensure that wealthy taxpayers pay at least some minimum amount of income tax. Over time, various changes to the AMT structure, along with the fact that its key parameters (e.g., the AMT exemption, the breakpoint between the AMT tax rates) were not indexed for inflation, worked to convert the AMT from a relatively minor add-on tax to a fairly significant feature of the U.S. federal income tax. In very general terms, the AMT can be described as having a broader base (because it features fewer deductions) and lower rates (with a top rate of 28 percent, as compared to 35 percent) than the regular income tax.

By far the most significant AMT preference item is the deduction for state and local taxes, accounting for more than two-thirds of total AMT preferences and adjustments in recent years.[19] As a result, AMT participation rates are highest in those states where state and local tax burdens are the greatest. The Urban-Brookings Tax Policy Center has estimated that, in 2007, "families in high-tax states were almost three times more likely to face the AMT than those in low-tax states." States with the highest number of total returns featuring AMT liability are California, Connecticut, Maryland, Massachusetts, New Jersey, and New York.

[17] Even outside the AMT context, taxpayers should generally prefer deductible charitable contributions to non-deductible 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 of course far less common in these contexts than in the income tax context.

[18] Leonard E. Burman, William G. Gale, and Jeffrey Rohaly, *The Expending Reach of the Individual Alternative Minimum Tax*, Urban/Brookings Tax Policy Center (May 2005).

[19] Tax Policy Center, Reconciling AMTI and Taxable Income for AMT Taxpayers (December 21, 2010) (deduction for state/local taxes accounted for more than 68% of AMT adjustments and preferences for 2008) (http://www.taxpolicycenter.org/taxfacts/Content/PDF/amt_preference.pdf).

C. *California AMT Data*

IRS data reveal more detail about the operation of the AMT in California. For taxable year 2010, approximately 4.5 percent of federal income tax returns filed in California showed some AMT liability. Nearly all of those returns (96 percent) were filed by taxpayers with adjusted gross income over $100,000, and three-quarters were filed by taxpayers with AGI in excess of $200,000.[20] Thus, as is true throughout the country, AMT liability of Californians is concentrated in the top decile of the income distribution.[21] For each of these taxpayers, an increase in their state tax liability will have no effect on their federal income tax liability because of the non-deductibility 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.[22]

III. Understanding the Effects of a California 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, where an individual or business entity engages the expertise of a tax lawyer or accountant with an eye toward minimizing their tax obligations. Rather, what we envision is state legislation enacted specifically for the purpose of exploiting the federal tax code's differential treatment of these two types of payments.

At this point, we offer our analysis merely as a thought experiment in the hopes of revealing the intuition underlying the idea. Our aim here is not to endorse a California state charitable tax credit—indeed, we have some doubts as to its viability as a means of capturing additional federal resources for the state. Rather we will highlight the technical

[20] IRS Statistics of Income (2010) (available at http://www.irs.gov/uac/SOI-Tax-Stats---Historic-Table-2).
[21] See Emmanuel Saez, *Striking it Richer: The Evolution of Top Incomes in the United States (Updated with 2009 and 2010 estimates)*, Figure 2 (March 2, 2012) (noting that the breakpoint for the top decile, based on national figures was $108,000 in 2010).
[22] 26 U.S.C. section 55(b)(1)(A)(i).

legal questions that would need to be answered to ensure that such a credit would have the desired effects.

A. *The (Potential) Federal Tax Benefits of a California Charitable Tax Credit*

The potential benefit of a state income tax credit for charitable contributions is best understood with an extreme example—i.e., a 100 percent California state income tax credit for donations to a California State Charitable Contribution Fund (CSCCF)—that we will refer to as *Example A*. Let us assume that the purpose of this fund will be to undertake some sort of activity that has the effect of defraying state general fund expenditures. Taxpayer Joe, with federal adjusted gross income in the $400,000-$500,000 range and subject to the federal AMT, plans to contribute $10,000 to this fund.

If respected as a charitable gift, this contribution will entitle Joe to (1) a $10,000 income tax credit on his California state income tax return, and (2) 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, this should be simply an accounting maneuver, at least insofar as CSCCF resources are used to defray general fund expenditures.

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 (since 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 experience 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.[23]

[23] 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. This would be the case, for example, with regard to 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, these taxes are generally not deductible for anyone. Thus, to the extent that a charitable contribution gives rise to (1) a federal income tax deduction for the full amount

The State of 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 bears a credit percentage of 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—i.e., 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, where 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 in the analysis, the reader is likely thinking (or, if not, perhaps should be), "this can't work." After all, the state income tax credit scheme described above has all the markings of a transparent tax avoidance scheme—i.e., mere paper shuffling and relabeling devised for the purpose of reducing federal tax liabilities. The fact that a state government is initiating the scheme does not make it any less objectionable on the grounds of "substance over form" or other such judicial anti-tax avoidance doctrines. The "right" answer, it seems to us, is 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* above, 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. This result seems to follow from the Treasury regulations discussed above.

Despite our attraction to these answers as the "correct" result, we see two problems. First, as explained in more detail below, the IRS has recently taken a contrary view,

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of the gift, and (2) a state tax credit for one of these non-deductible taxes, the effect is to convert the payment of a non-deductible tax to a deductible gift.

concluding that "a state or local tax benefit [e.g., 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 §170…" Second, for the IRS to hold otherwise would likely require a broader reconsideration of the longstanding principle that "[t]he 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." These passages are quoted from the Chief Counsel's 2010 memorandum on this issue, to which we now turn.

B. *IRS Chief Counsel Memorandum 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.[24] More specifically, the Memorandum considered, *inter alia*, whether a taxpayer's contribution of cash or other property to a state agency should be considered a charitable deduction under section 170 of the Internal Revenue Code ("Code") or payment of a state tax under section 164 of the Code 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 analysis can be summarized as follows. Over the course of two years, the taxpayers contributed cash and appreciated property to certain 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.

[24] While the memorandum can be viewed as the office's current position on the topic, it bears noting that the views expressed in the advice expressed in the memorandum "may not be used or cited as precedent." Office of Chief Counsel Internal Revenue Service, Memorandum No. 201105010 at 1 (Feb. 4, 2011).

In Year 1, the taxpayer submitted applications to the State Department of Economic Development 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 these contributions is relatively brief and straightforward. It begins with a standard recitation of black letter law concerning charitable contributions. To be deductible as a charitable contribution under section 170, the memo notes, "a transfer to a charitable organization or government unit must be a gift," defined here as "a transfer of money or property without receipt of adequate consideration, made with charitable intent." 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." Where 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 the principles just described 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's Memorandum, federal courts have 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."[25] In many of these cases, the court's conclusions are stated in very strong terms. For example, in *McLennan*, the U.S. Claims Court noted that that "a donation of property for the exclusive purpose of receiving a tax deduction does

[25] Citing McLennan v. United States, 23 Cl. Ct. 99 (1991), subsequent proceedings, 24 Cl. Ct. 102, 106 n.8 (1991), aff'd 994 F.2d 839 (Fed. Cir. 1993); Skripak v. Commissioner, 84 T.C. 285, 319 (1985); Allen v. Commissioner, 92 T.C. 1, 7 (1989), aff'd 925 F.2d 348 (9th Cir. 1991).

not vitiate the charitable nature of the contribution."[26] 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."[27]

The central question addressed in the Chief Counsel's Memorandum is whether a tax *credit* should be treated any differently than 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—i.e., 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 Chief Counsel refused to apply a different rule for tax credits than the one that already applies for tax deductions, concluding that "we see 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." This language seems to suggest that the same treatment accorded to a tax deduction where the taxpayer's marginal state income tax rate is 10 percent would also be extended to a situation where the taxpayer claims a state income tax credit, regardless of the statutory credit percentage. Significantly, however, the Memorandum also states that "*[t]here 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.*"

[26] McLennan v. United States, 23 Cl. Ct. 99 (1991), subsequent proceedings, 24 Cl. Ct. 102, 106 n.8 (1991), aff'd 994 F.2d 839 (Fed. Cir. 1993).
[27] Skripak v. Commissioner, 84 T.C. 285, 319 (1985).

We have italicized this language from the Chief Counsel's Memorandum because we believe it represents a silent recognition of the potential federal tax benefits to AMT taxpayers from claiming especially "generous" state tax credits for charitable contributions. To be sure, these benefits arise from the use of less generous state tax credits, as well as tax deductions. Indeed, any payment that reduces an AMT taxpayer's state income tax liability while increasing her charitable contribution deductions converts non-deductible 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, in the case of state charitable contribution deductions the benefit is unlikely to exceed one-tenth of the amount of the gift because state income tax rates only rarely exceed 10 percent.[28]

Where 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 where 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 hold the potential of generating resources for the state.

C. *Transferable Tax Credits under Tempel v. Commissioner*

To this point in the analysis, we have been assuming a program in which the state income tax credit may be utilized 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 the state income tax credit. This was precisely the type of statute that the taxpayers took advantage of in the case of *Tempel v. Commissioner*, a recent decision of

[28] 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 non-deductible taxes to $1,000 of deductible donations.

the U.S. Tax Court.[29] The *Tempel* case illustrates a further benefit that might be derived from the adoption of a state charitable tax credit.[30]

In December 2004, Colorado residents George and Georgette Tempel donated certain conservation easements to the Greenlands Reserve, a non-profit organization formed to promote environmental protection and open space through the acquisition of negative easements limiting development on the donated property. In an effort to encourage the transfer of easements to such organizations, Colorado granted donors a state income tax credit equal to (i) 100 percent of the first $100,000 of the value of the easement, plus (ii) 40 percent of the value of the easement in excess of $100,000. In no event could the credit exceed $260,000. These credits could be utilized by the donor to reduce their Colorado state income tax liability (and, under certain circumstances, could generate refunds) or 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 a value of the easements of $836,500, 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 Chief Counsel Memorandum 201105010, the IRS contended, and the taxpayers agreed, that the Tempels' "receipt of State tax credits as a result of their conservation easement contribution was [not] a quid pro quo transaction." For purposes of its analysis, the Court accepted this position. Because this issue was not in dispute, the Court's acceptance of the parties' stipulation should not be regarded an element of the holding in the case. Nevertheless, the Court's acceptance of the parties' stipulation on this issue, along with its own citation to Memorandum 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.

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[29] Tempel v. Commissioner, 136 T.C. No. 15 (2011).

[30] Erik M. Jensen, *The Sale of State Tax Credits: A Tax Court Decision Isn't a* Tempel *of Doom*, 28 Journal of Taxation of Investments 91 (2011); Erik M. Jensen, *The Sale of Tax Credits Revisited: A CCA Consecrates (Most of* Tempel*)*, 29 Journal of Taxation of Investments 59 (2012).

The central issue in the *Tempel* case 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 taxpayer had short-term capital gain from the sale of the credits in 2004. It also determined that the taxpayer had a zero basis in the credits, with the result that it experienced a gain of $30,375 from the December 2004 sale.

At first blush, this 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 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 only held the credits for more than one year they would have recognized long-term capital gain from the sale of the credits. In combination with the Chief Counsel's position that a taxpayer need not reduce her charitable contribution deduction by the value of the state tax benefits generated by the donation, the holding in *Tempel* appears to give donors the ability to convert ordinary income (taxed at a maximum statutory rate of 35 percent) to long-term capital gain (typically taxed at 15 percent).[31]

To illustrate, assume for the sake of analysis that the taxpayers in the *Tempel* case contributed a conservation easement worth $100,000 to Greenlands Reserve. Assume further that, rather than using 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

[31] 26 U.S.C. section 1(a), (h). 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.

liability by as much as $35,000 (i.e., $100,000 multiplied by the top marginal tax rate of 35 percent), the $100,000 gain from the sale of the credits increases their federal income tax liability by only $15,000 (i.e., $100,000 of long-term capital gain multiplied by the maximum rate on net capital gain of 15 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, the *Tempel* holding effectively empowers state governments to issue "capital gains coupons"—in the form of transferable state charitable tax credits. This outcome expands the population of taxpayers who could potentially 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 potentially 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.[32]

To illustrate the effects of this 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 Chief Counsel Memorandum 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 $35,000 (i.e., $100,000 multiplied by the top marginal rate of 35 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 (1) increasing his charitable contribution

[32] It 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* PLR 200348002 (August 28, 2003).

deduction by $100,000, and (2) 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 (1) deduct $100,000 as a charitable contribution deduction under the logic of Memorandum 201105010, and (2) 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 15 percent. Thus, the net benefit of the transaction is $20,000 to Dan (i.e., $35,000 less $15,000). 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 § 164 for State X income taxes paid with the purchased Credits."[33]

As with the non-transferable 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 (1) deduct $100,000 as a charitable contribution deduction in year 1 (tax savings of $35,000 based on a 35 percent tax rate), and (2) recognize $90,000 of long-term capital gain in year 2 (tax of $13,500 based on a 15 percent rate). Here the net benefit from the federal government is $21,500 but it is divided between Dan ($11,500) and the state government ($10,000).[34]

There are numerous variations on these stylized hypotheticals that could illustrate the effects in slightly different circumstances, involving taxpayers subject to higher or lower marginal tax rates, state credits for taxes other than income taxes, credits that could be

[33] PLR 200348002 (August 28, 2003).

[34] In effect, Dan has converted $90,000 of ordinary income into long-term capital gain, reducing the tax on that $90,000 of income by 20 percentage points (35% to 15%) for a tax savings of $18,000 and he is also getting the benefit of tax savings at the rate of 35% for the $10,000 "real" gift for a tax savings of $3,500. So Dan parts with $10,000 (net payment to State) but gains $21,500 in federal tax savings for a net benefit to Dan of $11,500 and a net benefit to the State of $10,000.

used by businesses to offset their tax liability, etc... While each of these 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. California's Proposed Tax Credit for Donations to Cal Grants

To this point in the analysis we have left unspecified the types of public programs that could benefit from a state charitable tax credit program. As noted in Part 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. California State Senator Kevin 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 IRS Chief Counsel Memorandum 201101050, the federal AMT's differential treatment of charitable contributions and state/local taxes, and the Tax Court's decision in *Tempel.*

A. *The Higher Education Investment Tax Credit*

In early 2012, Senator Kevin de León introduced SB 1356, legislation that would have established a new *Higher Education Investment Tax Credit Program Special Fund* ("HEITCP"). The HEITCP is designed to provide new funding for Cal Grants, a state-funded program, as noted above, that provides financial aid to low- and middle-income students to attend college.[35] One rationale underlying SB 1356 is the significant

[35] California Senate Bill 1356 (2012); de León, K., *Backgrounder on SB 1356 – Higher Education Income Tax Credit Fund*, (2012).

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 has declined by 46 percent during 1990-2012.[36] In absolute dollar terms, California has reduced funding for public post-secondary institutions by $1.4 billion during 2006-2012.[37] SB 1356 appears to be motivated by a desire to temper these effects by increasing funds available for middle-income households hoping to pursue postsecondary education.

The mechanism by which the HEITCP aimed to accomplish this goal is precisely the one we have been describing in this chapter—i.e., 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 HEITCP in calendar year 2013.[38] The tax credit was to be reduced by 10 percent in both 2014 and 2015 after which point the program would end.[39] The program fund was capped at $100 million annually.[40]

Applying the analysis discussed above in Part III, a gift to the HEITCP would generate two significant tax benefits for the donor. First, the taxpayer would be entitled to a state income tax credit in the amount of 60 percent of the amount of the gift (assuming a gift in 2013). Second, applying the logic of Chief Counsel Memorandum 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 HEITCP of $100,000, which under SB 1356 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, this gift should (1) entitle her to a charitable contribution deduction of $100,000 on her federal income

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[36] John Quintermo, *The Great Cost Shift: How Higher Education Cuts Undermine the Future Middle Class* 16 (Demos Public Policy Research, March 2012).
[37] Illinois State University, Grapevine – An annual compilation of data on state fiscal support for higher education, (2012)
http://grapevine.illinoisstate.edu/tables/FY12/Revised_March13/Table%201%20Revised.pdf; State Higher Education Executive Officers, State Higher Education Finance FY 2011, http://www.sheeo.org/finance/shef/SHEF_FY11.pdf
[38] California Senate Bill 1356 Sec. 1(a)(1)(A) (2012).
[39] *Id.* at Sec. 1(a)(1)(B) (2012).
[40] *Id.* at Sec. 1(b)(1) (2012).

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 the State of California increase by $40,000 and her overall federal deductions increase by $40,000. For purposes of analysis, 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" since it is effectively refunded to her via the state tax credit. Elena's federal income tax burden drops by $14,000, which is simply the $40,000 true gift portion of her donation multiplied by the top rate of 35 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.

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

$$(1) \qquad G(1-f)(1-s)$$

or

$$(2) \qquad G(1-f-s+fs)$$

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 35 percent and applying the HEITCP credit percentage of 60 percent, the after-tax cost of a $100,000 gift is $100,000 x $(1-.35)(1-.60)$ or $26,000. Intuitively, this can be described as a combination of the following: (1) a gross cash outflow of **$100,000**, (2) *minus* **$35,000** 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* **$21,000** in increased federal taxes arising from the $60,000 reduction in the federal deduction for state/local taxes.

The key thing to note here is that even though Elena is saving $35,000 in federal taxes by virtue of her $100,000 charitable contribution deduction, she is also increasing her federal tax payments by $21,000 by virtue of losing $60,000 in deductions for state and local taxes. In effect, because Elena loses $60,000 worth of California state/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 non-deductible 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 HEITCP will similarly (1) entitle her to a charitable contribution deduction of $100,000 on her federal income tax return, and (2) reduce her state income tax liability by $60,000. Significantly, however, the reduction in state income tax liability in this scenario has no effect on Elena's state/local tax deduction because state/local taxes are not deductible for AMT taxpayers. 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—i.e., $100,000 gross gift multiplied by a marginal tax rate of 28 percent (i.e., the top rate for AMT taxpayers).

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

$$(3) \qquad G(1 - f - s)$$

which differs from equation (2) above only 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/local deductions that effectively rendered the "faux gift" portion of the donation non-deductible. Because an AMT taxpayer has no state/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 the analysis just presented, we can see that an AMT taxpayer making a $100,000 donation to the HEITC special fund has a net out-of-pocket cost of only $12,000—i.e., $100,000 minus $28,000 (in federal tax savings) minus $60,000 (in state tax savings). Clearly the tax savings for this type of donation are well in excess of the tax savings normally arising from charitable gifts. AMT taxpayers willing to make a gross gift of one dollar to Cal Grants will be reimbursed a total of 88 cents, consisting of 60 cents from the State of California and 28 cents from the federal governments.

As currently structured, SB 1356 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 of doing this would be to increase the credit percentage. Any credit percentage greater than 72 percent would ensure that donors experience no out-of-pocket cost 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 Alternative Minimum Tax (AMT), … the tax benefits received exceed the out-of-pocket cost."[41]

B. *Expanding the (Potential) Benefits of SB 1356*

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 SB 1356 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 HEITC program need not be limited to AMT taxpayers. Building from the analysis in Part III, we note two possible changes to the HEITC framework that could expand the reach of its benefits.

First, to the extent that the tax credit is transferable, the Tax Court's recent decision in the *Tempel* decision discussed above suggests 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 would actually 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—i.e., the "$+fs$" term

[41] George Woodard, *Expansion of Private School Tuition Tax Credit Program* (May 8, 2012) http://www.hhcpa.com/blogs/income-tax-accountants-cpa/expansion-of-private-school-tuition-organization-tax-credit-program).

in equation (2). By selling the credit after a year, the taxpayer experiences a different and smaller federal tax increase (this can be portrayed by replacing the "$+fs$" 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 HEITC fund, which entitles him to a \$60,000 credit that he sells 13 months later for \$58,000. Under the logic of 201105010, he should be able to claim a deduction of \$100,000 for the donation, which assuming a federal tax rate of 35 percent saves him \$35,000 in federal income taxes. The subsequent sale of the credit for \$58,000 (zero basis) generates a tax of \$8,700 (\$58,000 x 15%). Thus, while Peter experiences an initial cash outlay of \$100,000, he recoups \$84,300 from federal tax savings and the later sale of the credits to a third party.

Second, the benefit of the HEITC program 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 not only to AMT taxpayers but also (and even more so) attractive to high-bracket itemizing taxpayers not subject to the AMT. This 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 as a result qualify for a \$60,000 sales tax credit, she would (1) be able to claim a \$100,000 charitable contribution deduction under the logic of CCA 201105010, and (2) 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 as 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 \$35,000 (assuming a 35 percent federal tax rate). In form, Lakshmi is donating $100,000 to a good cause. In substance, one might say that she is (1) donating $40,000 to a good cause, and (2) purchasing a $60,000 prepaid sales tax debit card. Because of Memorandum 201105010, *both* of these amounts appears as deductions on her federal income tax return in the form of a $100,000 charitable gift, saving her $35,000 in federal income taxes.

Of course, 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 a small business owner or productive entrepreneur. Still, given the IRS position in CCA 201105010, it is understandable why a state may wish to partner with its taxpayers to promote charitable gifts to state agencies.

V. Conclusion

As we have noted, 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 well suggest that these 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.