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Federal tax breaks for donating to these state-run funds are on shaky ground

- The Tax Cuts and Jobs Act imposed a $10,000 limit on the state and local tax deduction, prompting some states to establish charitable funds.
- A rule from the Treasury and IRS that will address these "workarounds" is now in its final stage and under review at the Office of Information and Regulatory Affairs.
- This regulation could have a chilling effect on pre-existing charitable tax-credit programs in more than 33 states.

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Things are looking uncertain for filers hoping to get a break on their 2018 federal taxes by contributing to state-run charitable funds.

The Tax Cuts and Jobs Act, which went into effect last year, limited to $10,000 the state and local tax (SALT) deduction filers can claim on their federal returns.

And only taxpayers who itemize deductions would be eligible to claim this break. The new tax law increased the standard deduction to $12,000 for singles and $24,000 for married-filing-jointly in 2018.

High-tax states, including New York, New Jersey and Connecticut, responded with a workaround: They passed legislation that would permit municipalities to create charitable funds to pay for local services and offer property tax credits to incentivize homeowners to give.

This way, donors would be able to claim a charitable deduction on their federal tax returns, bypassing the $10,000 cap on SALT deductions.

A final rule from the Treasury and IRS that would block these workarounds — and potentially other state tax credit programs in South Carolina, Alabama and elsewhere, that existed before the new tax law — is now under review by the Office of Information and Regulatory Affairs.

That means it's up in the air as to whether taxpayers who gave to state-sponsored charitable funds will be able to take a break on their federal returns for 2018.

"The regulations that the IRS issued didn't carve out a section for those pre-existing programs, and some people thought they would," said Michael D'Addio, a principal at Marcum.

There are more than 100 existing state charitable tax-credit plans in 33 states, a research paper authored by a group of tax law professors found.

These programs range from conservation easements to contributions to private school tuition scholarships.

Here's how it works: Donors to these programs collect a credit against their state income tax liability. They can also claim a charitable deduction on their federal income tax return for the contribution.

The IRS and Treasury's proposed rule throws some cold water on these programs: They want taxpayers to reduce the charitable deduction they claim on their federal return by the amount of any state or local tax credit they get back.

Tax Play

States place an annual cap on the amount of credits available to donors.

For instance, the Alabama Opportunity Scholarship Fund offers a total of $30 million in state tax credits each year.

Individuals may donate the equivalent of up to 50 percent of their state income tax liability, up to $50,000.

Alabamans get back a dollar-for-dollar tax credit on their state return.

Ambiguity around the federal tax treatment of these donations has led to a slowdown in giving since the 2019 funding cycle started on Jan. 1, according to Lesley Searcy, executive director of the Alabama Opportunity Scholarship Fund.

"At this time last year, all of the credits — $30 million — were exhausted," she said. "We now have $24 million in credits remaining."

"What we're hearing from donors and tax preparers is that they're waiting for the final rules to see what they look like," she said.

Taxpayers who give to the Exceptional SC program in South Carolina, a scholarship fund for children with exceptional needs, have also been hesitant this year, said Chad Connelly, executive director of that program.

South Carolinians who give to the program can claim a dollar-for-dollar credit on their state income tax liability, up to 60 percent of their state tax liability for that year.

"I'm seeing some hesitation due to the lack of clarity from the IRS," said Connelly. "Compared to last year, I would say it's a slower pace."

Regulatory ambiguity

Whether taxpayers who gave to these funds in 2018 can claim a charitable deduction on their federal return for that year is also uncertain.

The IRS and Treasury's proposed rule had an effective date of Aug. 27, 2018.

If you made a contribution to a state fund after that date and then claimed it on your 2018 federal tax return as a charitable donation, you're risking a showdown with the IRS, said Daniel Rosen, partner in the North America Tax Practice Group at Baker & McKenzie.

"If the final regulations are issued with the retroactive date of Aug. 27, 2018, you'll have to report on your return that you're taking a position that's inconsistent with the regulation," he said.

"You've bought yourself a fight," Rosen said.

Donors who want to continue giving to these funds will need to consider the extent to which the federal tax break matters to them.

"Certainly losing a federal benefit is a significant calculus to anyone looking to make a contribution to a state charitable fund," said Rosen.

"But if you're not motivated by the desire to get a deduction at the federal level, then your decision-making shouldn't be affected by pending regulatory action," he said.