

IRS Issues Notice on Payments Made in Exchange for State and Local Tax Credits

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On May 23, 2018, the Department of the Treasury and the Internal Revenue Service (IRS) issued Notice 2018-54, stating that proposed regulations will be issued addressing the deductibility of certain payments made by taxpayers to state-operated charitable funds and entities in exchange for a partial credit against their state and local tax liability. The notice provides no actual guidance except to remind taxpayers that federal law controls the characterization of such payments for federal income tax purposes, regardless of their tax treatment under state law.

The Tax Cuts and Jobs Act (P.L. 115-97) (TCJA) limits an individual's deduction under Section 164 of the Internal Revenue Code (Code) for state and local taxes paid during the calendar year to \$10,000 (\$5,000 in the case of a married individual filing a separate return). In response, some states, including California, Connecticut, Illinois, New York and New Jersey, have adopted or are considering legislation that would allow taxpayers to make payments to specified state-operated charitable funds and entities in exchange for a partial tax credit against state and local taxes. The aim of these proposals is to allow taxpayers to satisfy their state and local tax liabilities with payments that are intended to be fully deductible charitable contributions for federal income tax purposes.

The proposed regulations, which are intended to be issued in the near future, will address the federal income tax treatment of transfers by taxpayers to funds controlled by state and local governments (or other state-specified transferees) that the taxpayer can treat in whole or in part as satisfying its state and local tax obligations. Notice 2018-54 provides that proposed regulations will make clear that the requirements of the Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers. The proposed regulations are intended to help taxpayers understand the relationship between federal charitable contribution deduction and the TCJA's limitation on the deduction of state and local taxes.

In the news release accompanying Notice 2018-54, the IRS warned that taxpayers should also be aware that the Department of the Treasury and the IRS are continuing to monitor other legislative proposals to ensure that federal law controls the characterization of deductions for federal income tax filings. Thus, legislation like New York's recently enacted Employer Compensation Expense Program, Connecticut's tax on pass-through entities and other similar proposals intended to address the TCJA's new limit on state and local deductions would also likely be covered by the proposed regulations. For more information on New York's recently enacted response to the TCJA, see our April 9, 2018, client alert, "[New York State Responds to Federal Tax Reform](#)."

Certain key government officials, including House Ways and Means Chairman Kevin Brady, Treasury Secretary Steven Mnuchin and Acting IRS Commissioner David Kautter, have criticized state initiatives that would allow taxpayers to avoid the TCJA's limitation on state and local tax deductions and have expressed skepticism as to whether they work for federal income tax purposes.

The limitation imposed by the TCJA applies to taxable years beginning after December 31, 2017, and before January 1, 2026.