The Heritage Foundation

# BACKGROUNDER

No. 3350 | SEPTEMBER 12, 2018

## A Technical Correction to Address the Impact of the State and Local Tax Deduction Cap on State-Based Tax Credit Scholarship Programs

*Adam N. Michel, Lindsey Burke, and Jonathan Butcher*

**Abstract**

*The Tax Cuts and Jobs Act made the federal income tax more neutral toward state tax policy by limiting the SALT deduction to $10,000. By not completely eliminating the deduction, the SALT cap created unintended opportunities for some taxpayers to access undue tax benefits. Treasury rules to implement the new SALT cap and prohibit state workarounds will raise the cost for some taxpayers of donating to existing state-based tax credit scholarship programs that are needed to maximize parental choice in education and enable children to access diverse learning options. The final Treasury rule should re-establish the federal tax system's neutrality toward state tax credit programs.*

The Tax Cuts and Jobs Act (TCJA) of 2017 was the most comprehensive update to the federal tax code in more than 30 years. Although the primary goal of the reform was economic growth and job creation, an important secondary goal was making the federal tax code more neutral toward state tax policy.

The new $10,000 cap on the federal deduction for state and local taxes (SALT) accomplished the bipartisan goal of moving the federal tax code toward fairer treatment of similar taxpayers in different states. To implement the SALT cap as intended by Congress, the Treasury Department recently released a notice of proposed rulemaking to disallow the use of new state tax credit schemes set up to game the charitable deduction and circumvent the SALT cap.[1]

For certain taxpayers who do not max out their SALT deduction, the proposed rule increases the cost of donating to existing legitimate state-based tax credit scholarship programs. In some cases, the cost of donating will increase from zero to as much as 37 percent of the donation amount.

### Key Points

- State-based tax credit scholarship programs increase private school choice and are available to students in 18 states.
- Tax credit scholarship programs allow state taxpayers to receive a full (dollar-for-dollar) or partial tax credit against their state tax obligations for their contribution to a nonprofit scholarship-granting organization.
- As part of the Tax Cuts and Jobs Act, the $10,000 cap on the state and local tax (SALT) deduction accomplished the goal of making the tax code more neutral toward state tax policy.
- Treasury rules to implement the new SALT cap and prohibit undue tax benefits will raise the cost of donating to existing tax credit programs for about 10 percent of federal taxpayers.
- A technical correction for affected taxpayers would better align the proposed rule with congressional intent and isolate existing programs from any unintended and adverse effects.

This paper, in its entirety, can be found at **http://report.heritage.org/bg3350**

**The Heritage Foundation**
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

The most widely used state-based tax credit programs are tax credit scholarship programs, which are an important and growing tool for expanding school choice. The exact impact of the Treasury proposal is still uncertain, but a technical correction for affected taxpayers would better align the proposed rule with congressional intent and insulate existing programs from unintended and adverse impacts.

## The State and Local Tax Deduction

An important goal of the TCJA was to create federal tax neutrality with respect to state tax policy. Capping the federal deduction for state and local taxes moved the federal tax code toward this bipartisan aim of more equal treatment. The unlimited SALT deduction created an inequity in the federal tax code that allowed taxpayers with identical incomes to pay hundreds of thousands of dollars more or less in federal taxes based entirely on their state of residency.[2]

Under pre-TCJA law, taxpayers who itemized their taxes could deduct an unlimited amount of their taxes paid to state and local governments from their federal taxable income. At the federal level, the deduction reduces the income subject to tax rather than creating a one-for-one credit. Beginning in 2018 under the new tax law (baseline), the deduction is limited to $10,000 of property taxes and income taxes (or sales taxes).[3] The new SALT cap does not extend to c-corporations.

Various other changes in the TCJA compensate taxpayers for the effect of the SALT cap, which in isolation would raise taxes on many high-income taxpayers. However, most taxpayers who are subject to the new SALT cap will see lower marginal tax rates and have the option of taking the larger standard deduction—and for those with pass-through businesses, there is a new 20 percent deduction for qualified income.[4] After accounting for all the changes in the TCJA, including the SALT cap, about 90 percent of Americans will see a tax cut or no change.[5]

## States' Attempts to Preserve SALT for High-Income Taxpayers

Lawmakers in New York, New Jersey, and Connecticut have passed laws to allow their high-income residents to sidestep the new $10,000 cap by re-characterizing state taxes as charitable contributions, which are not subject to the new cap. These new state programs offer dollar-for-dollar or high percentage state credits in lieu of taxes paid for contributions to "charities" that directly supplement state functions or fund general revenue. In many ways, the structure of these entities follows a similar structure to tax credit scholarship programs and other similar tax credit programs that existed before the TCJA.

These new state-run "charities," contributions to which are matched by an offsetting state tax credit, are different in their motivation, but may not be legally distinguishable from legitimate nonprofits and charitable organizations.[6] The motivation behind the establishment of these new state-based entities is to provide credits in lieu of taxes to allow savvy high-income taxpayers to circumvent the new SALT cap. By contrast, state-based scholarship-granting organizations (SGOs) have existed for decades in order to provide scholarships to eligible children to attend a private school of choice.[7]

1. "Contributions in Exchange for State or Local Tax Credits," RIN 1545–BO89, *Federal Register*, Vol. 83, No. 166 (August 27, 2018).
2. Adam N. Michel, "The SALT Cap Is Fair Treatment for States and Congressional Districts," Heritage Foundation *Issue Brief* No. 4898, August 29, 2018, https://www.heritage.org/taxes/report/the-salt-cap-fair-treatment-states-and-congressional-districts.
3. The deduction is limited to $5,000 for married couples filing separately.
4. Adam N. Michel, "Analysis of the 2017 Tax Cuts and Jobs Act," Heritage Foundation *Issue Brief* No. 4800, December 19, 2017, https://www.heritage.org/taxes/report/analysis-the-2017-tax-cuts-and-jobs-act.
5. Kevin Dayaratna, Parker Sheppard, and Adam N. Michel, "Tax Cuts in Every Congressional District in Every State," Heritage Foundation *Backgrounder* No. 3333, July 23, 2018, https://www.heritage.org/taxes/report/tax-cuts-every-congressional-district-every-state.
6. See discussion in Jared Walczak, "State Strategies to Preserve SALT Deductions for High-Income Taxpayers: Will They Work?" Tax Foundation *Fiscal Fact* No. 569, January 2018, https://taxfoundation.org/state-strategies-preserve-state-and-local-tax-deduction (accessed September 6, 2018); Phillip Blackman and Kirk Stark, "Capturing Federal Dollars with State Charitable Tax Credits," Tax Notes, April 1, 2013, http://sd24.senate.ca.gov/sites/sd24.senate.ca.gov/files/Capturing%20Federal%20Dollars%20with%20State%20Charitable%20Tax%20Credits%20%28April%202013%29.pdf (accessed September 6, 2018); and Carl Davis, "SALT/Charitable Workaround Credits Require a Broad Fix, Not a Narrow One," Institute on Taxation and Economic Policy, May 2018, https://itep.org/salt-charitable-workaround-credits-require-a-broad-fix-not-a-narrow-one/ (accessed September 6, 2018).
7. States refer to these organizations with different abbreviations. In Arizona, for example, the organizations are called school tuition organizations (STOs).

## State-Based Tax Credit Scholarship Programs

State-based tax credit scholarship programs are an important part of the private school choice landscape. Now available to students in 18 states, tax credit scholarship programs allow state taxpayers to receive a full (dollar-for-dollar) or partial tax credit against their state tax obligations for their contribution to a nonprofit SGO. The SGO then provides a scholarship to an eligible child to attend a private school of choice. Programs vary by state, and can include both individual and corporate donors. Although the scholarship functions much the same way as a voucher for an eligible student, the scholarships are privately funded by individuals or corporations that contribute to SGOs.[8] Vouchers, by contrast, are typically funded through state appropriations.

More than 270,000 children benefit from tax credit scholarships in 18 states: Alabama, Arizona (four programs), Florida, Georgia, Illinois, Indiana, Iowa, Kansas, Louisiana, Montana, Nevada, New Hampshire, Oklahoma, Pennsylvania (two programs), Rhode Island, South Carolina, South Dakota, and Virginia. Florida, for example, provides a dollar-for-dollar tax credit to corporations against their state income tax and insurance premium tax obligations for donations to SGOs. Florida's tax credit scholarship—the largest school choice program in the country—currently provides scholarships worth up to $8,525 per year, per student, to 107,000 children. Those children are attending nearly 1,800 participating private schools of choice, enabling thousands of families across the Sunshine State to find a school that is the right fit for their child.[9]

**Fiscal Effects of Tax Credit Scholarship Programs.** As noted, Florida's tax credit scholarship program is the largest in the country, making the Sunshine State a good case study of the potential fiscal effects of the policy. Most students enrolled in the Florida tax credit scholarship program would have otherwise attended a public school. As such, the Florida Office for Program Policy Analysis and Government Accountability found that during the 2007–2008 school year, the tax credit scholarship program saved $1.49 for every $1.00 in foregone revenue.[10] More recently, Florida's Consensus Revenue Estimating Conference found that the scholarship program saved $57.9 million during the 2012–2013 school year.[11] An analysis of the fiscal effects of tax credit scholarships across the country by EdChoice found that the Florida tax credit scholarship program saved between $372 million and $549 million since its inception in 2001 (or between $1,122 and $1,658 per student since program enactment). Cumulatively tax credit scholarship programs have saved taxpayers between $1.7 billion and $3.4 billion through the 2013–2014 academic year.[12]

**Participant Outcomes.** Not only can tax credit scholarship programs save money for taxpayers, but the ability for parents to select into private schools that are the right match for their children can also lead to improved academic and attainment outcomes. To date, scholars have conducted 17 rigorous evaluations of the effect of school choice programs on student academic achievement. Among the 17 randomized controlled trial evaluations examining the impact of school choice on academic achievement, 11 found positive impacts for some

8. *Arizona Christian School Tuition Organization v. Winn et al.*, 563 U.S. 125 (2011).
9. "The ABCs of School Choice: The Comprehensive Guide to Every Private School Choice Program in America," 2018 Edition, EdChoice, https://www.edchoice.org/school-choice/school-choice-in-america/# (accessed September 7, 2018).
10. Office of Program Policy Analysis and Government Accountability, "The Corporate Income Tax Credit Scholarship Program Saves State Dollars," Report No. 08-68, December 2008, http://www.oppaga.state.fl.us/MonitorDocs/Reports/pdf/0868rpt.pdf (accessed September 7, 2018).
11. Step Up for Students, "Tax Credit Scholarship Financial Costs: Every Study Shows the Scholarships Save State Tax Money," March 2017, https://www.stepupforstudents.org/wp-content/uploads/17.3-TAX-CREDIT-SCHOLARSHIP-Cost-Savings.pdf (accessed September 7, 2018).
12. Martin F. Lueken, "The Tax-Credit Scholarship Audit: Do Publicly Funded Private School Choice Programs Save Money?" Ed Choice, October 2016, https://www.edchoice.org/wp-content/uploads/2017/03/Tax-Credit-Scholarship-Audit-by-Martin-F.-Lueken-UPDATED.pdf (accessed September 7, 2018).

or all participants,[13] four evaluations found neutral or null effects on academic achievement,[14] and two evaluations found statistically significant negative effects on academic achievement as a result of scholarship use.[15] To date, researchers have conducted three randomized controlled trial evaluations examining the impact of school choice on academic attainment. One of those studies found statistically significant increases in graduation rates for participants while the other two evaluations did not find statistically significant effects on attainment, but did identify significant positive effects for minority students on college enrollment.[16]

## The Need for Tax Credit Scholarship Programs

Prudent tax policy—whether at the state or federal level—should maintain low tax rates on a tax base that does not discourage savings and investment. Complicating the tax code through a myriad of tax credits and deductions can mask true government expenditures and insulate governments from pressure to keep rates low. Traditional tax credits—which are government spending by another name—are distinct from programs that allow donations in lieu of taxes or what are often referred to as "tax credit programs." Allowing state taxpayers to earmark their tax payments with tax credits for K–12 education is good and necessary policy for several reasons.

13. Kaitlin P. Anderson and Patrick J. Wolf, "Evaluating School Vouchers: Evidence from a Within-Study Comparison," University of Arkansas EDRE *Working Paper* No. 2017-10, April 3, 2017, http://www.uaedreform.org/downloads/2017/04/evaluating-school-vouchers-evidence-from-a-within-study-comparison.pdf (accessed September 7, 2018); Patrick J. Wolf et al., "School Vouchers and Student Outcomes: Experimental Evidence from Washington, DC," *Journal of Policy Analysis and Management*, Vol. 32, No. 2 (Spring 2013), pp. 246–270, https://eric.ed.gov/?id=EJ1010252 (accessed September 7, 2018); John Barnard et al., "Principal Stratification Approach to Broken Randomized Experiments: A case study of School Choice Vouchers in New York City," *Journal of the American Statistical Association*, Vol. 98 (2003), pp. 299–323, https://pdfs.semanticscholar.org/72b0/00085d50afead4713a8f8cc296c75d1ddda1.pdf (accessed September 7, 2018); William G. Howell et al., "School Vouchers and Academic Performance: Results from Three Randomized Field Trials," *Journal of Policy Analysis and Management*, Vol. 21, No. 2 (2002), pp. 191–217, https://onlinelibrary.wiley.com/doi/abs/10.1002/pam.10023 (accessed September 7, 2018); Hui Jin, John Barnard, and Donald B. Rubin, "A Modified General Location Model for Noncompliance with Missing Data: Revisiting the New York City School Choice Scholarship Program Using Principal Stratification," *Journal of Educational and Behavioral Statistics*, Vol, 35, No. 2 (2010), pp. 154–173, http://journals.sagepub.com/doi/abs/10.3102/1076998609346968?journalCode=jebb (accessed September 7, 2018); Joshua M. Cowen, "School Choice as a Latent Variable: Estimating the 'Complier Average Causal Effect' of Vouchers in Charlotte," *Policy Studies Journal*, Vol. 36, No. 2 (2008), pp. 301–315, https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1541-0072.2008.00268.x (accessed September 7, 2018); Jay P. Greene, "Vouchers in Charlotte: Vouchers and the Test-Score Gap," *Education Next*, Vol. 1, No. 2 (Summer 2001), https://www.educationnext.org/vouchersincharlotte/ (accessed September 7, 2018); Jay P. Greene, Paul E. Peterson, and JiangtaoDu, "Effectiveness of School Choice: The Milwaukee Experiment," *Education and Urban Society* (1999), http://journals.sagepub.com/doi/10.1177/0013124599031002005 (accessed September 7, 2018); and Cecilia Elena Rouse, "Private School Vouchers and Student Achievement: An Evaluation of the Milwaukee Parental Choice Program," *The Quarterly Journal of Economics*, Vol. 113, No. 2 (May 1998), pp. 553–602, http://faculty.smu.edu/millimet/classes/eco7321/papers/rouse.pdf (accessed September 7, 2018).
14. Jonathan N. Mills and Patrick J. Wolf, "The Effects of the Louisiana Scholarship Program on Student Achievement After Two Years," Education Research Alliance for New Orleans, June 26, 2017, https://educationresearchalliancenola.org/files/publications/Mills-Wolf-Effects-of-LSP-on-Student-Achievement-After-Three-Years.pdf (accessed September 7, 2018); Marianne Bitler et al., "Distributional Analysis in Educational Evaluation: A Case Study from the New York City Voucher Program," *Journal of Research on Educational Effectiveness*, Vol. 8, No. 3 (2015), pp. 419–450, https://www.ncbi.nlm.nih.gov/pmc/articles/PMC4507830/ (accessed September 7, 2018); Eric Bettinger and Robert Slonim, "Using Experimental Economics to Measure the Effects of a Natural Educational Experiment on Altruism," *Journal of Public Economics*, Vol. 90, No. 8–9 (2006), pp. 1625–1648, https://econpapers.repec.org/article/eeepubeco/v_3a90_3ay_3a2006_3ai_3a8-9_3ap_3a1625-1648.htm (accessed September 7, 2018); and Alan B. Krueger and Pei Zhu, "Another Look at the New York City School Voucher Experiment," *American Behavioral Scientist*, Vol. 47, No. 5 (2004), pp. 658–698.
15. Mark Dynarski et al., "Evaluation of the DC Opportunity Scholarship Program: Impacts Two Years After Students Applied," Institute of Education Sciences, National Center for Education, Evaluation, and Regional Assistance, 2018, https://ies.ed.gov/ncee/pubs/20184010/pdf/20184010.pdf (accessed September 7, 2018), and Atila Abdulkadiroglu et al. "Do Parents Value School Effectiveness?" National Bureau of Economic Research *Working Paper* No. 23912, October 2017, http://www.nber.org/papers/w23912 (accessed September 7, 2018).
16. Matthew M. Chingos and Paul E. Peterson, "Experimentally Estimated Impacts of School Vouchers on College Enrollment and Degree Attainment," *Journal of Public Economics*, Vol. 122 (2015), pp. 1–12, https://ideas.repec.org/a/eee/pubeco/v122y2015icp1-12.html (accessed September 7, 2018); Matthew M. Chingos and Paul E. Peterson, "The Impact of School Vouchers on College Enrollment," *EducationNext*, Vol. 13, No. 3 (Summer 2013), pp. 59–64, https://www.educationnext.org/the-impact-of-school-vouchers-on-college-enrollment/ (accessed September 7, 2018); and Wolf et al., "Evaluation of the DC Opportunity Scholarship Program: Final Report," Institute of Education Sciences, National Center for Education, Evaluation, and Regional Assistance, 2010, https://ies.ed.gov/ncee/pubs/20104018/pdf/20104018.pdf (accessed September 7, 2018).

First, every state compels children to attend elementary and secondary school, usually from around age six to around age 17.[17] Second, not only is education compulsory, but for the vast majority of American schoolchildren, that education takes place in a district school assigned by their state or local government based on their neighborhood of residence. Residential assignment policies, combined with compulsory schooling, effectively mean that most children are required to attend school at a government-assigned location. Although private school choice programs have enjoyed marked growth across the country since the early 2000s—increasing from just four programs in 2000 to 63 programs in 29 states and the District of Columbia in 2018—they account for fewer than 500,000 students overall. Approximately 90 percent of America's nearly 57 million schoolchildren attend public schools, many of them assigned by zip code.[18] Third, parents who wish to send their child to something other than a public school must be able to afford to pay twice: once in taxes to support the public system, and a second time to finance private school tuition, something many, if not most, American families are unable to afford.

This trifecta of K–12 education policy—compulsory, assigned, and publicly funded—warrants the establishment of tax credit scholarship programs (and related school choice options, such as vouchers and education savings accounts) in the states because individuals then have options from which to choose in making decisions in their best interest. Tax credit scholarships give the parents of children the opportunity to exercise choice in where and how that education is delivered. Such options also enable donors to SGOs—whether corporate or individual—to support education options that align with their values and goals, while also maximizing the education possibilities available to families in a given state. Tax credit scholarship programs are needed to maximize parental choice in education, enabling children to access learning options that are the right fit for them.

## SALT Causes Problems for SGOs

The SALT cap made the federal tax code more neutral toward state tax-rate decisions, but because the deduction was not fully eliminated, the cap created two potential loopholes for programs that offer credits for contributions in lieu of taxes. First, the cap allows taxpayers who have maxed out their SALT deduction to receive tax benefits greater than their donation. Second, without a legal distinction between legitimate charitable causes (such as SGOs) and the newly created SALT cap workaround credit programs, the SALT cap would be easily gamed, making the new limit effectively meaningless.

Even the most generous interpretations of past precedent lead most observers to conclude that the new workaround credits should not be allowed. However, the similarity of the new workaround credits and long-standing state tax credit programs presents a regulatory challenge. Under prior law, IRS guidance and various court cases restricted the charitable deduction by the amount the taxpayer benefits.[19] A fundraiser dinner that cost $200 to attend, and included $50 worth of food, would only be eligible for a $150 federal write-off. Under prior law, however, the IRS did not include state benefits, such as tax credits, in its assessment of charitable contributions; while the new SALT cap workaround credits are clearly a quid pro quo benefit.[20]

Even if regulators are able to delineate between true charitable causes and entities set up for the sole purpose of circumventing the SALT cap, the new deduction limit creates a second problem. Under prior law, the characterization of a contribution as charitable giving with an offsetting tax credit did not matter for the purposes of federal tax liability. As shown in Appendix Table 1, a $1,000 donation to

17. National Center for Education Statistics, "State Education Reforms, 'Table 5.1. Compulsory school attendance laws, minimum and maximum age limits for required free education, by state: 2017,'" https://nces.ed.gov/programs/statereform/tab5_1.asp (accessed September 7, 2018).
18. National Center for Education Statistics, "Fast Facts: Elementary and Secondary Education, Enrollment," https://nces.ed.gov/fastfacts/display.asp?id=372 (accessed September 7, 2018).
19. Walczak, "State Strategies to Preserve SALT Deductions for High-Income Taxpayers: Will They Work?"
20. Office of Chief Counsel IRS Memorandum No. 201105010, October 27, 2010 (released February 4, 2011), https://www.irs.gov/pub/irs-wd/1105010.pdf (accessed September 7, 2018).

a 100 percent, dollar-for-dollar tax credit program increases the charitable deduction by $1,000 and decreases the state tax deduction by $1,000. With the exception of certain taxpayers subject to the alternative minimum tax (AMT), there was no federal revenue impact of state tax credit programs.[21]

Under the current law SALT cap, without the Treasury proposal summarized below, individual taxpayers who have maxed out their SALT deduction and give to a state tax credit program can receive tax benefits in excess of their donation amount. For a taxpayer who is more than $1,000 above the SALT cap, Appendix Table 1 shows that a $1,000 donation to a 100 percent tax credit program does not reduce the SALT deduction, but still increases the federal charitable deduction. The taxpayer in the example donates $1,000 and receives $1,240 in state and federal tax savings.

Whether the charity is legitimate or not, the tax code should not allow someone to "make money" by donating to a charity. Under current law, without any restrictions on tax credit programs, the goal of federal neutrality toward state tax policy is violated. It is crucial to find a way to preserve the important function of tax credit scholarship programs, which enable thousands of families across the country to exercise education choice, rather than having their children assigned to a government-assigned district school.

## Treasury's Proposed Regulations Do Not Fix the Problem

To combat SALT cap workarounds and limit any ability to make money through charitable donations, the Department of the Treasury recently published a notice of proposed rulemaking ("the proposal") for contributions in exchange for state or local tax credits. The proposal reduces the amount of the charitable deduction (often to zero) by the value of the state tax credit.[22]

The proposal simply requires taxpayers to reduce their federal charitable deduction dollar for dollar by the value of any state or local tax credit they received in exchange for their donation. A taxpayer who donates $1,000 to a state tax credit program with a 100 percent dollar-for-dollar credit could not claim any of the $1,000 as a charitable deduction on his federal income taxes. If, instead, the state offers an 80 percent tax credit, the taxpayer could claim $200 of the $1,000 donation as a charitable deduction on the federal tax return.

At first blush, the proposal makes sense intuitively; just reduce the charitable donation by the amount that the state gives back in the form of lower state taxes. And, in general, the proposal does make the new workaround credits ineffective, disallowing any profit opportunities, while still allowing taxpayers to earmark their state tax dollars to truly charitable endeavors like SGOs.

However, as drafted, the proposal has one major unintended consequence: For a select group of taxpayers who choose to itemize their deductions but do not reach their SALT cap that year, the cost of donating to existing tax credit programs will increase significantly. Under the TCJA current law baseline, approximately 16 percent of filers are expected to itemize their taxes, and of those who itemize, about 61 percent will be below the SALT cap.[23] For the nearly 10 percent of individual taxpayers who do not face the SALT cap, the proposal makes the federal tax code non-neutral to state tax policy.

Under the proposal, individual taxpayers who are above the SALT cap are denied the charitable deduction because the static cap eliminates the ability for the two deductions (state tax deduction and charitable deduction) to offset one another. However, a taxpayer who is below the SALT cap and contributes $1,000 to a tax credit program with a 100 percent credit would face a $1,000 smaller state tax write-off, but would be prohibited from claiming the $1,000 as a federal charitable deduction. The net cost to the taxpayer of a $1,000 contribution to a 100 percent state tax credit program could be $240. (See Appendix Table 2.)

Tax credit incentivized donations remain relatively attractive compared to traditional charitable donations. However, for certain middle-income tax-

21. Under prior law, taxpayers subject to the AMT faced a similar dynamic as taxpayers above the SALT cap under current law. The AMT denies the SALT deduction but allows the charitable deduction. Under the AMT, the potential for similar tax benefits existed, however, specific cases of such activity have not been recorded.

22. "Contributions in Exchange for State or Local Tax Credits," RIN 1545–BO89, *Federal Register*.

23. Heritage Foundation calculations using the Heritage Foundation Individual Income Tax Model.

payers, the proposal significantly raises the cost of working with SGOs and denies states the ability to allow their own taxpayers to earmark part of their state taxes to causes they believe in.

As currently written, the new cost of donating to tax credit programs only exists for middle-income Americans who have not maxed out their $10,000 SALT deduction. Wealthier taxpayers, who pay higher overall taxes, can make the same donation at zero cost to them. The proposal creates a new inequity in the federal tax code that disfavors certain middle-income Americans and impedes crucial options that expand school choice.

Since the original notice of proposed rulemaking was issued, the IRS clarified in a September 5 press release that the proposal does not prevent businesses from deducting their donations because payments to state and local tax credit programs are still deductible as business expenses.[24] Because the corporate SALT deduction is not subject to the $10,000 cap, c-corporations are not expected to face a similar increase in the tax cost of donating because the business expense deduction is still available. If for whatever reason the tax cost of contributing to SGOs is positive, it would effectively eliminate corporate participation in tax credit scholarship programs, and thousands of children who currently rely on these programs would have to return to assigned government schools.

## Full SALT Repeal Is the Best Solution

The SALT deduction is poor federal tax policy, and the TCJA rightly began to limit the write-off. The $10,000 cap—and more generally limiting the deduction to the greatest extent possible—is an important policy reform to better align state and local policymakers' incentives with the economic effects of high taxes. The cap treats the states fairly and supports good state and local governance. However, the cap is only an intermediate reform.

The problems created by the cap and resulting proposed Treasury regulations are the product of not completely eliminating the deduction for all taxpayers. To further simplify and tax code and enhance the system's fairness, the SALT deduction should be permanently eliminated for both individuals and c-corporations in future legislation.

Congress could capitalize on the success of the TCJA by fully repealing the SALT deduction and codifying the Treasury proposal to reduce the charitable deduction by any benefit received. The problems created for some individuals described above would be eliminated. The correct policy response is full SALT repeal and codification of the proposed rule.

## An Interim Technical Correction to the Treasury Proposal

Federal tax policy should be neutral toward state tax policy. Fully eliminating the SALT deduction would accomplish this goal. A more limited correction to the current proposed rule could better align the tax code with congressional intent by restoring federal neutrality toward state tax credits for charitable contributions. Individuals and businesses not constrained by the SALT cap should be able to continue to deduct charitable donations, regardless of the state tax consequence. This proposal will not reduce federal revenues and maintains equal treatment between taxpayers.[25]

More precisely, the value of the federal charitable deduction for a state tax credit program should be reduced by the difference between the $10,000 cap and the individual taxpayer's SALT deduction that year (that is, how far they are below the SALT cap). For taxpayers who have maxed out their SALT deduction, nothing changes from the Treasury proposal. But taxpayers below the SALT cap would still be able to claim at least a portion of their federal charitable deduction while claiming the tax credit on their state tax return, as they did under pre-TCJA law.

For example, if an individual taxpayer claims $9,500 in SALT deductions this year and has donated $1,000 to a 100 percent tax credit scholarship fund, he could still write off $500 in SALT deductions and $500 as a federal charitable donation. If a taxpayer claimed $9,500 in SALT deductions and donated $1,000 to a 60 percent tax credit scholarship, she could write off the $400 of uncompensated donation value as a straight charitable donation. Of the

24. Internal Revenue Service, "Clarification for Business Taxpayers: Payments Under State or Local Tax Credit Programs May Be Deductible as Business Expenses," IR-2018-178, September 5, 2018, https://www.irs.gov/newsroom/clarification-for-business-taxpayers-payments-under-state-or-local-tax-credit-programs-may-be-deductible-as-business-expenses (accessed September 6, 2018).

25. From the Treasury baseline, the proposed rule and our proposed technical correction may actually raise revenue. The Treasury proposal would raise more revenue compared to the technical correction.

remaining $600 of their donation—the amount equal to their state tax credit—they could write off $500 (the difference between the $10,000 SALT cap and their existing $9,500 SALT deductions), for a total charitable deduction of $900. This fix would make it so that all individual taxpayers donating to a 100 percent tax credit organization could continue to do so without incurring a personal cost, while continuing to limit the ability for taxpayers to receive undue tax benefits from donations.

Business' continued ability to deduct contributions to state tax credit organizations as business expenses provides necessary relief from proposed regulation. However, Treasury should still extend the same technical correction for individuals described above to corporate tax returns. In the corporate case, the new rule would not limit the charitable deduction for tax credit programs because c-corporations are not subject to the $10,000 SALT cap. The continued access to the business expense deduction, as described by the IRS September 5 press release, may re-open the door for some pass-through businesses (those who pay taxes as individuals) to access undue tax benefits. Restricting the business expense deduction by the value of associated tax credits only for those above the SALT cap could address concerns that some businesses could still access undue benefits.

The final rule must not create positive tax cost for business participation in state tax credit programs. Applying the technical correction to all tax filers would treat all taxpayers equally, would better prepare the regulatory structure for future reforms that could limit the corporate SALT deduction, and would prevent unintended workarounds.

## Conclusion

The TCJA made the federal income tax more neutral toward state tax policy by limiting the SALT deduction for individual taxpayers to $10,000 annually. By not fully eliminating the deduction, however, the SALT cap created unintended interaction effects that vary depending on income level and state tax systems. The correct policy solution is the full repeal of the SALT deduction for individuals and businesses as part of tax reform 2.0.

To prevent undue tax benefits from SALT cap workaround credits, Treasury issued proposed regulations to limit a taxpayer's ability to claim a charitable deduction for state tax credit incentivized contributions. In a world with no SALT deduction, this is the appropriate rule to avoid gaming of the tax code. Because the SALT deduction was not fully eliminated, taxpayers not subject to the $10,000 SALT cap are penalized for contributing to SGOs and other similar tax credit organizations. The final Treasury regulations should re-establish the federal tax system's neutrality toward state tax credit programs. This can be accomplished by limiting the federal charitable deduction for state tax credit programs by the difference between the taxpayer's SALT cap, if any, and the taxpayer's actual SALT deductions that year.

*—**Adam N. Michel** is Policy Analyst in the Thomas A Roe Institute for Economic Policy Studies, of the Institute for Economic Freedom, at The Heritage Foundation. **Lindsey Burke** is Director of, and Will Skillman Fellow in, the Center for Education Policy, of the Institute for Family, Community, and Opportunity, at The Heritage Foundation. **Jonathan Butcher** is Senior Policy Analyst in the Center for Education Policy.*

## Appendix 1: Comparing Scenarios for Two Married Couples

Two married couples filing jointly in Arizona itemize their federal deductions and will pay more than $1,000 in state taxes. Each year, they donate $1,000 to a private school tuition organization that provides scholarships to students to attend private schools in Arizona. The State of Arizona allows them to take a $1,000 tax credit against their state income tax liability. Couple A pays state taxes in excess of the $10,000 SALT cap and Couple B pays less than $10,000 in state and local taxes. Both couples face a 24 percent federal marginal tax rate.[26]

**Prior Law.** In 2017, Couples A and B donated to the tuition organization and claimed the $1,000 tax credit. Because of the 100 percent tax credit, the donation was no state tax cost to the couples. The donation did not affect the couples' federal tax bill either. Their state tax credit lowered the SALT deduction by the same amount that the charitable deduction increased—their federal itemized deductions for state taxes and charitable contributions were exactly offset. Under prior law, the couples' federal tax liability was indifferent to and unaffected by their state's tax policy. See column 1 in Appendix Table 1 and Appendix Table 2.

**TCJA Baseline (Without Treasury Regulations).** For Couple A, who pays more than $1,000 above the SALT cap, Appendix Table 1 shows that a $1,000 donation to a 100 percent tax credit program does not reduce the SALT deduction, but still increases the federal charitable deduction. Couple A can donate $1,000 and hypothetically receive $1,240 in state and federal tax savings. Couple A receives a tax savings of $240 more than their donation.

**Treasury Proposed Regulation.** In 2018, both couples plan to make their same $1,000 donation and will receive the $1,000 state tax credit, leaving their state tax bill unchanged. However, following the TCJA and if the Treasury's proposed regulations

APPENDIX TABLE 1

### Couple A: Change in Taxes Paid for a Taxpayer Above the SALT Cap

FOR A $1,000 DONATION TO A DOLLAR-FOR-DOLLAR STATE TAX CREDIT ORGANIZATION

| | Prior Law | Baseline | Treasury Rule | Heritage Rule |
|---|---|---|---|---|
| State Income Tax Liability | –1,000 | –1,000 | –1,000 | –1,000 |
| Federal Income Tax: | | | | |
| Charitable Contribution Deduction | 1,000 | 1,000 | 0 | 0 |
| Deduction for State and Local Taxes | –1,000 | 0 | 0 | 0 |
| Itemized Deductions | 0 | 1,000 | 0 | 0 |
| Taxable Income | 0 | –1,000 | 0 | 0 |
| Federal Tax Liability | 0 | –240 | 0 | 0 |
| Total Tax Benefit (Federal + State) | 1,000 | 1,240 | 1,000 | 1,000 |
| Net Cost to Taxpayer of $1,000 Contribution | 0 | –240 | 0 | 0 |

**SOURCE:** Heritage Foundation research.

BG3350 heritage.org

26. Our example builds on a similar case study presented in the proposed regulation. "Contributions in Exchange for State or Local Tax Credits," RIN 1545–BO89, *Federal Register*.

APPENDIX TABLE 2

## Couple B: Change in Taxes Paid for a Taxpayer Above the SALT Cap

FOR A $1,000 DONATION TO A DOLLAR-FOR-DOLLAR STATE TAX CREDIT ORGANIZATION

| | Prior Law | Baseline | Treasury rule | Heritage rule |
|---|---|---|---|---|
| State Income Tax Liability | –1,000 | –1,000 | –1,000 | –1,000 |
| Federal Income Tax: | | | | |
| Charitable Contribution Deduction | 1,000 | 1,000 | 0 | 1,000 |
| Deduction for State and Local Taxes | –1,000 | –1,000 | –1,000 | –1,000 |
| Itemized Deductions | 0 | 0 | –1,000 | 0 |
| Taxable Income | 0 | 0 | 1000 | 0 |
| Federal Tax Liability | 0 | 0 | 240 | 0 |
| Total Tax Benefit (Federal + State) | 1,000 | 1,000 | 760 | 1,000 |
| Net Cost to Taxpayer of $1,000 Contribution | 0 | 0 | 240 | 0 |

**SOURCE:** Heritage Foundation research.

are finalized in their current form, Couple B's federal taxable income will increase by $1,000 (Appendix Table 2). Under the Treasury proposal, the charitable contribution decreases by the value of the state tax credit, so Couple B is denied any charitable write-off. The $1,000 donation to the tuition organization will increase Couple B's tax bill by $240. This husband and wife would be better off just paying their taxes.

For Couple A, the same $1,000 donation is costless. For this couple, the $1,000 state tax credit lowers the state tax liability, but does not change the federal SALT deduction because Couple A is already over the maximum deduction amount (Appendix Table 1). Lowering their state tax bill from, say, $15,000 to $14,000 does not change their $10,000 federal SALT deduction. Couple A can choose to support school choice programs at no cost.

**Heritage Analysts' Proposed Technical Correction.** In order to restore federal neutrality toward state tax credit programs, taxpayers not subject to the SALT cap (Couple B) should be allowed to deduct the donation as a charitable contribution regardless of the state tax credit value. Couple B's $1,000 tax credit donation will lower the SALT deduction, but this husband and wife will be allowed to claim the contribution as a charitable contribution. The contribution is costless to Couple B, giving them the same tax treatment as Couple A.