IRS Says Not So Fast to States' Attempts to Convert High State and Local Tax Obligations to Charitable Deductions to Escape TCJA Limitations

05/24/2018

In Notice 2018-54, the IRS has notified taxpayers that proposed regulations are forthcoming which will deny state attempts to convert a taxpayer’s state and local tax obligations to a charitable deduction in order to avoid the limitations on the deductibility of state and local taxes under the Tax Cuts and Jobs Act (TCJA).

Under the TCJA, state and local taxes paid by a taxpayer during a calendar year may only be deducted up to an aggregate amount of $10,000 ($5,000 in the case of a married taxpayer filing separately), regardless of whether the true state and local taxes paid by that taxpayer were in excess of those amounts. (Prior to TCJA, the total amount of state and local taxes paid could be deducted.) The effect of the TCJA’s limitation is largest among high earning taxpayers and moderate-to-high earners in high-taxing states.

Given this sudden loss of the excess portion of that deduction, many state legislatures have explored or adopted legislation which would allow taxpayers to pay over their state taxes to a state or local government-controlled fund in exchange for credits against the tax that the taxpayer was required to pay to those governmental entities. In effect, the legislatures are attempting to change the state tax payment into a charitable deduction under federal tax law, while still satisfying the taxpayer’s tax obligations under state and local law.

The IRS is calling foul. Applying the substance over form doctrine, the IRS has telegraphed in its Notice that it will recharacterize such arrangements and disallow any deduction for state and local taxes that exceed the TCJA allowances, regardless of how such payments are characterized by the taxpayer. The IRS’s regulatory guidance is forthcoming, but its Notice puts taxpayers on notice that such arrangements will subject them to tax, penalties, and interest for such violations. Taxpayers should expect the forthcoming regulations to include similarly-structured methods and plans.