THE POWER NOT TO TAX

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Among the most controversial changes in federal tax policy in recent years is the new limitation on the deductibility of state and local taxes—or SALT cap. Introduced as part of the Tax Cuts and Jobs Act of 2017, the SALT cap differentially burdens residents of high-tax "blue states," prompting some lawmakers to characterize the cap as an act of "economic civil war." In one of the opening salvos of this "war," a handful of blue states turned to alternative devices for raising revenue through the use of tax credits for charitable donations to state-designated funds. This strategy, modeled on long-standing "red state" tax credits used to fund private school vouchers, is rooted in the government's "power not to tax," understood here as the power to conditionally refrain from imposing taxes in exchange for the taxpayer making some legislatively sanctioned outlay. The introduction of the SALT cap has given new significance to this power not to tax, encouraging state and local lawmakers to devise strategies for funding public goods without utilizing formal tax mechanisms. This Article explores and evaluates the structural features of the law that account for this new state of affairs, as well as the ongoing controversy regarding how best to address the basic discontinuity in the law's treatment of formal taxation versus conditional reductions in taxation. It also provides a blueprint for an alternative federal tax framework based on the uniform treatment of "social contributions"—i.e., a broader category of outlays including both taxes paid to state and local governments as well as charitable gifts.

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INTRODUCTION

Of the many controversial features of the Trump administration's signature tax legislation, the Tax Cuts and Jobs Act of 2017 (TCJA),[1] which took effect in 2018, perhaps the most contentious was the new limitation on the deductibility of state and local taxes. Under that provision, for tax years 2018 to 2025, individual taxpayers may deduct only $10,000 in state and local taxes paid.[2] Under previous law, in place from the beginning of the modern income tax in 1913 through 2017, deductions for state and local taxes were largely unlimited and thus provided substantial federal assistance to the funding of state and local public goods. As a result of the new limitation, taxpayers now face a significant increase in the after-tax cost of funding education, health care, environmental protection—and a wide range of other essential services—particularly in "blue states" where voters have typically demanded service levels requiring higher tax burdens.[3]

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1. Tax Cuts and Jobs Act (TCJA), Pub. L. No. 115-97, § 11042, 131 Stat. 2054, 2085 (2017) (amending I.R.C. § 164(b), adding a new paragraph, (6)).

2. *Id.*

3. The six states bearing the greatest burden from the change include California, Connecticut, the District of Columbia, Maryland, New Jersey, and New York. *See* Frank Sammartino et al., *The Effect of the TCJA Individual Income Tax Provisions Across Income Groups and Across the States*, TAX POL'Y CTR., Mar. 28, 2018,

Not surprisingly, lawmakers representing these states have not responded favorably to the new limits on the federal deductibility of state and local taxes (SALT). Shortly after TCJA's enactment New York Governor Andrew Cuomo asserted that the SALT cap "pillage[s]" states with higher tax burdens, fomenting an "economic civil war."[4] Once the SALT cap took effect, New York and several other states began considering legislation aimed at restoring the ability of their residents to fund state and local public services on a tax-favored basis. States have considered a wide range of options, including shifting from nondeductible income taxes to deductible payroll taxes and imposing new entity-level taxes on pass-throughs, such as partnerships and LLCs. But the most controversial response has been for states to provide tax credits for charitable gifts to funds established by state and local governments to support public goods. In the months following TCJA's enactment, numerous states considered such legislation and by mid-2018 Connecticut, New York, New Jersey, and Oregon had enacted legislation authorizing such charitable tax credits.[5]

The Trump administration's initial response to these efforts alternated between dismissive and derisive. The President's former chief economic advisor, Gary Cohn, was the first to express skepticism about state efforts to plan around the new SALT deduction limits, responding to questions from a reporter on a cable news show.[6] Shortly

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https://www.taxpolicycenter.org/publications/effect-tcja-individual-income-tax-provisions-across-income-groups-and-across-states [https://perma.cc/5FLE-6TG5].

4. Lauretta Brown, *Cuomo Claims GOP Tax Bill 'Pillages' Blue States, Creates 'Economic Civil War'*, TOWNHALL (Dec. 28, 2017, 2:10 PM), https://townhall.com/tipsheet/laurettabrown/2017/12/28/ny-gov-cuomo-says-gop-tax-bill-pillages-blue-states-n2427826 [https://perma.cc/X7UR-PCD2].

5. 2018 N.Y. Sess. Laws 229, 265 (McKinney); 2018 N.J. Sen. 1893, 218th Gen. Assemb., Reg. Sess. (N.J. 2018). Similar legislation has been introduced in several other states—including California, Colorado, the District of Columbia, Illinois, Nebraska, Rhode Island, Virginia, and Washington, to name just a few. Brian Tumulty, *Eight States May Follow New York's Workaround for SALT Deduction Limits*, BOND BUYER (Apr. 6, 2018), https://www.bondbuyer.com/news/eight-states-may-follow-new-yorks-workaround-for-salt-deduction-limits [https://perma.cc/GV8F-P2RA]. *See, e.g.*, Cal. Assemb. B. 2217, 2017 Assemb., Reg. Sess. (CA 2017) (seeking to allow taxpayers an 80% credit against income taxes owed for contributions to the Bridget "Biddy" Golden State Credit Program).

6. Alexis Leondis, *Gary Cohn Says Government May Push Back Against State Tax Workarounds*, BLOOMBERG (Jan. 5, 2018, 10:43 AM), https://www.bloomberg.com/news/articles/2018-01-05/cohn-says-government-may-push-back-against-state-tax-workarounds-jc22ggqt [https://perma.cc/8B84-LFAK].

thereafter Treasury Secretary Steve Mnuchin called the idea of treating gifts to local governments as deductible charitable contributions "ridiculous."[7] Like Governor Cuomo's remarks about a pending economic civil war, the initial reaction from Trump Administration officials provided more heat than light. While commentary from the political class tended toward the deliberatively provocative, officials with expertise in the tax law issued more cautious statements, noting initially that they were following state-level developments.[8] In late August 2018, the Internal Revenue Service (IRS) issued proposed regulations addressing this issue, and in June 2019, these regulations were finalized, accompanied by a notice indicating that additional regulatory guidance would be forthcoming.[9] Meanwhile, the state of New York and the town of Scarsdale have initiated litigation in federal court challenging the validity of these regulations.[10] On the legislative front, Democrats in the U.S. Senate forced a vote of the full chamber on a resolution that sought to overturn the new regulations pursuant to the Congressional Review Act.[11] Although the resolution did not pass, its consideration highlights the ongoing political salience of state responses to the SALT cap.

The primary objective of this Article is to look beyond the blustery rhetoric regarding these so-called "SALT workaround" strategies and evaluate the structural features of the tax law at the heart of the ongoing controversy regarding their legal viability. The primary allure of state charitable tax credit programs, whether enacted before or after the SALT cap, derived from a basic discontinuity in the federal tax law's treatment of two methods of funding state and local legislative priorities: (1) imposing taxes and appropriating the resulting revenue (i.e.,

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7. Jonathan Curry, *Mnuchin Dismisses SALT Workarounds, Charitable Giving Concerns*, 158 TAX NOTES 310 (2018).

8. *See* Fred Stokeld, *Treasury Monitoring State Proposals on Charitable Donations and State Taxes*, 158 TAX NOTES 607, 607 (2018) (noting statement from Treasury Tax Legislative Counsel that the department would "monitor developments as they happen across states").

9. Contributions in Exchange for State or Local Tax Credits, 83 Fed. Reg. 43563, 43571 (Aug. 27, 2018) (proposed rule); Contributions in Exchange for State or Local Tax Credits, 84 Fed. Reg. 27513, 27530 (June 13, 2019) (finalized rule).

10. David McKay Wilson & Joseph Spector, *Why NY, NJ, CT and Scarsdale Are Suing the IRS over Tax-Deduction Limits*, LOHUD (July 17, 2019, 12:42 PM), https://www.lohud.com/story/news/politics/politics-on-the-hudson/2019/07/17/why-ny-nj-ct-and-scarsdale-suing-irs-tax-deduction-limit/1754920001 [https://perma.cc/V3E6-XKJQ].

11. Naomi Jagoda, *Senate Rejects Dem Measure to Overturn IRS Rules on SALT Deduction Cap*, HILL (Oct. 23, 2019), https://thehill.com/policy/finance/467158-senate-rejects-dem-measure-to-overturn-irs-rules-on-salt-deduction-cap [https://perma.cc/BE5B-R5N7].

"tax and spend") and (2) providing charitable tax subsidies via deductions, credits, and other devices for transfers made directly by taxpayers to certain legislatively specified organizations (i.e., "tax expenditures").

Anyone with an elementary understanding of tax policy, particularly as it has evolved in the United States over the past half century, will appreciate the parallels between these two methods of financing public goods. While formal government appropriations typically require formal taxation as a source of funding, "tax expenditures" accomplish the same result not through actual government outlays but rather by a conditional reduction of tax liability. The distinction is chiefly one of form, a point cleverly illustrated by the late public finance economist, David Bradford. As Bradford explained, a government hoping to acquire weapons for national defense need not purchase them from manufacturers with tax revenues, but instead, could simply provide manufacturers a "weapons supply tax credit" in exchange for the weapons.[12] The two approaches accomplish the same substantive result (the acquisition of weapons) but the former entails the imposition of a formal tax coupled with appropriations, while the latter actually "reduces" the overall tax burden.

The controversy over SALT workarounds is, at its core, a debate regarding the appropriate federal income tax treatment of state and local tax expenditures for charitable outlays. That is, when a state or local government decides to "fund" some legislative priority using the charitable tax expenditure approach (providing tax credits in exchange for donations) rather than the formal tax and spend approach (collecting taxes and appropriating revenues), how should federal tax law treat a taxpayer whose formal tax liability has been conditionally reduced? Should she be treated as having made a charitable gift? Or should she instead be treated as having made a de facto payment of tax?

If federal law allows a deduction for both taxes and charitable gifts, then the taxpayer will likely be indifferent as to how the outlay is treated—either way she is entitled to a federal income tax deduction. For better or for worse, however, federal tax law has not always treated charitable gifts and SALT payments the same. Since at least 1986, when Congress eliminated the deduction for state and local taxes for

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12. David Bradford, *Reforming Budgetary Language*, *in* PUBLIC FINANCE & PUBLIC POLICY IN THE NEW CENTURY 93–116 (Sijbren Cnossen & Hans-Werner Sinn eds., 2003). *See also* Ariz. Christian Sch. Tuition Org. v. Winn, 563 U.S. 125, 148 (2011) (Kagan, J., dissenting) (asserting that formal taxation and reduction of tax liability through credits are essentially interchangeable because they both "accomplish[] the same government objective").

purposes of the alternative minimum tax,[13] federal law has disfavored the "tax and spend" approach relative to the "tax expenditures" approach for funding state and local expenditures. During this period, many states enacted exceptionally generous charitable tax expenditures, typically in the form of high percentage state tax credits (including many 100% state tax credits) for donations to government entities, government-created funds, and nonprofits.[14] In every case, these credits had the function and purpose of funding some legislatively determined program or activity through the conditional reduction of donors' tax liabilities.

The extent to which these programs may have been motivated by the federal tax preference just described is unclear.[15] Nevertheless, the availability of such generous state tax credits gave taxpayers the opportunity to mitigate the adverse effects of not being able to deduct state and local taxes for purposes of the alternative minimum tax (AMT) by making federally deductible gifts that reduced their state and local tax obligations.[16] This same point can be framed as an

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13. Tax Reform Act of 1986, Pub. L. No. 99-514, § 56, 100 Stat. 2085, 2322 (1985).

14. There are over 100 such programs in place in thirty-three states, including several that feature 100% state income tax credits. *See* Joseph Bankman, et al., *Federal Income Tax Treatment of Charitable Contributions Entitling Donor to a State Tax Credit*, 159 STATE TAX NOTES App. A (2018) (providing examples of state-supported charities in each state).

15. In the case of private school voucher tax credits, an important rationale for using tax credits rather than direct government spending appears to have been a desire to circumvent constitutional limitations arising from the First Amendment's Establishment Clause. *See Ariz. Christian Sch. Tuition Org.*, 563 U.S. at 148.

16. Financial advisors have long highlighted the tax benefits of donating to these organizations for AMT taxpayers. *See, e.g.*, Jamey Parker, *Charitable Giving Can Be a Win Win!*, TKW BLOG (Aug. 2013), https://tkw.com/wp-content/uploads/2013/08/Charitable-Giving-Can-Be-a-Win-Win.pdf [https://perma.cc/W2HP-HHDS] (noting that Oregon state tax credits have the effect of "shifting your federal itemized deduction from state tax expense, which is not deductible in computing AMT to charitable contributions"); David Slade, *'Donation' Can Make You a Profit*, POST & COURIER (July 12, 2014), https://www.postandcourier.com/business/donation-can-make-you-a-profit/article_412688ac-87ef-5077-af48-a37ce59fb932.html [https://perma.cc/84WJ-E7AJ] (describing benefit to AMT taxpayers of making deductible gifts to South Carolina's Exceptional SC fund, which entitles donors to 100% state tax credit); Bryan Strike, *Charitable Donation and State Tax Credit!*, KAYS FINANCIAL ADVISORY CORPORATION, PROFESSIONAL WEALTH MANAGEMENT SERVICES (Sept. 20, 2016), https://www.scottkays.com/article/2016/09/20/charitable-donation-state-tax-credit [https://perma.cc/XCW3-B3PY] (describing tax advantages for AMT taxpayers to make deductible gifts to Georgia's Student Scholarship Organizations, which entitle donors to 100% state tax credit).

element of charitable tax planning. For donors considering alternative charitable transfers, gifts reducing the donor's state or local tax liability became relatively more attractive for taxpayers subject to the AMT.[17] This strategy, which benefited only AMT taxpayers from 1987 to 2017, acquired significantly broader appeal after the introduction of the SALT cap in 2018. By limiting the SALT deduction, not just for AMT taxpayers but for everyone, TCJA substantially increased the number of taxpayers for whom relative state and local tax savings has become an relevant factor in making charitable gifts—whether those gifts are made to private universities, public elementary schools, or any other type of donee described in section 170(c) of the Internal Revenue Code.[18]

Much of the initial commentary about state charitable tax credit proposals focused on whether they would "work" or "pass muster" with the IRS or the courts.[19] While interest in this question is understandable, especially given the polarized political environment and the ongoing litigation on this matter, this binary frame obscures both the structural source of the problem and its continuous nature. To be sure, state charitable tax credits set to 100% (as with many existing private school voucher tax credits) are the most eye-catching examples, since with these programs, the donor could potentially fully

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17. *See, e.g.*, Kathleen Pender, *Huge Tax Break for Donating to California College Students*, S.F. CHRON. (Oct. 3, 2014, 5:41 PM), https://www.sfgate.com/business/networth/article/Huge-tax-break-for-donating-to-California-college-5800035.php [https://perma.cc/B295-9X3N] (demonstrating that a taxpayer not subject to the AMT would pay $2,680 in taxes if he applied the credit, rather than the $1,200 owed if the taxpayer was subject to the AMT); Sarah K. Johnson, *Making a Profit from Charitable Donations in South Carolina*, 73 STATE TAX NOTES 527, 531 (2014) (explaining that taxpayers in different tax brackets would be impacted disparately based on whether they were subject to AMT, with those in the lower brackets benefiting more).

18. Various commentators highlighted this effect of the law before it was enacted. *See, e.g.*, Manoj Viswanathan, *How SALT Deduction Repeal Promotes State Capture of Federal Charitable Contributions*, SURLY SUBGROUP, (Nov. 9, 2017), https://surlysubgroup.com/2017/11/09/-how-salt-deduction-repeal-promotes-state-capture-of-federal-charitable-contributions [https://perma.cc/RQ6A-354J] (observing that "many more taxpayers could take advantage of state-level initiatives that essentially reclassify state and local tax payments as federal charitable contributions").

19. *See, e.g.*, Peter L. Faber, *Charitable Funds and the Disallowance of Federal Income Tax Deductions for State and Local Taxes*, MCDERMOTT, WILL & EMERY (Mar. 28, 2018), https://www.mwe.com/insights/charitable-funds-disallowance-federal-income [https://perma.cc/66QD-PQSY] (observing that "any attempt to mitigate its effects must pass muster under established principles of the common law of taxation"); Amandeep S. Grewal, *The Charitable Contribution Strategy: An Ineffective SALT Substitute*, 38 VA. TAX REV. 203, 206 (2018) (examining whether the charitable contribution strategy works).

replicate SALT deductibility by making a qualifying charitable gift. But even a state tax credit of 15% or 20% (or, for that matter, a standard state income tax deduction for charitable giving) enables a donor to circumvent the SALT cap to the extent of the tax savings derived from making the federally deductible gift. Put differently, *any* state or local tax savings derived from making *any* federally deductible outlay represents a de facto breach of the $10,000 cap on the SALT deduction.

The essential point is that any tax savings from making a charitable gift (including the tax savings derived from the federal deduction itself) constitutes a "workaround" in that the taxpayer is reducing her nondeductible tax liability by making a deductible gift. And because the scope of donees eligible to receive federally deductible charitable contributions is so broad (including state governments themselves, along with their political subdivisions), state and local governments have considerable latitude to use tax expenditures to steer resources toward their own legislative priorities while giving donor-taxpayers the opportunity to claim a federal charitable contribution deduction.

Paradoxically, in a world where both state and local taxes and charitable gifts are deductible, states lack this ability. This is because any state or local charitable tax subsidy is offset by a reduced SALT deduction. But by limiting the SALT deduction, Congress gave state and local governments both the opportunity and the incentive to exercise their power not to tax and to direct charitable dollars toward state and local legislative priorities.

Of course, the federal government could change the law to reduce or even eliminate the incentive state and local governments to make use of their power not to tax. The recently finalized Treasury regulations attempt to do just that.[20] But as we shall see, this is no simple task. Among other things, this approach requires developing a jurisprudence of "constructive taxation" to identify the circumstances under which relief from potential taxation (via deductions, credits, and other such mechanisms) constitutes a de facto payment of tax.[21] And even if such a regime could be easily implemented, it leaves us with a federal tax system that, ironically and perversely, confers substantial tax benefits on charitable contributions to nonprofits (rendering these "gifts" less charitable) but withholds those benefits

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20. *See infra* note 95.

21. *See, e.g.*, Ariz. Christian Sch. Tuition Org. v. Winn, 563 U.S. 129, 148 (2011) (Kagan, J., dissenting) ("[B]ecause appropriations and tax breaks can achieve identical objectives, the government can easily substitute one for the other.").

for tax payments to the same entities (rendering them more charitable). This paradox flows from the basic illogic of treating substantively similar transfers differently, and it could be avoided by subjecting charitable contributions and state and local taxes to uniform treatment,—e.g., making both deductible, disallowing a deduction for both, or subjecting both to a uniform floor/ceiling limitation. Such an approach would accord with the economic reality that both types of outlays represent a type of "social contribution" warranting equivalent treatment.

The Article is divided into four parts. Part I begins by providing background on the federal income tax treatment of charitable contributions and state and local taxes, as well as some basic data about how taxpayers in different states made use of these deductions in the years leading up to the enactment of TCJA. Part II then discusses how the government can use its "power not to tax" (i.e., the use of deductions, credits, and other tax benefits) to direct private resources to fund legislative priorities without relying on formal taxes, as well as how federal law has traditionally treated charitable outlays that give rise to such tax benefits. As Part II explains, by limiting the deductibility of state and local taxes, TCJA intensified an existing incentive in federal law for state and local governments to rely on tax expenditures in pursuing legislative priorities over the more conventional approach of collecting formal taxes to fund formal expenditures.

Part III then provides a description and analysis of the recently finalized SALT workaround regulations. While these regulations are meant to address the discontinuity described in Part II, and in many ways take an admirably principled approach to the controversy, the approach adopted is incomplete and thus will likely serve only as a half-measure. That incompleteness derives from an understandable reluctance to spell out clearly the full implications of the logic underlying the regulations. The regulations imply (but stop short of actually stating) that the portion of the donor/taxpayer's payment that is disallowed as a charitable contribution deduction is, in substance, a payment of tax and thus should be treated as a "constructive tax." The problem with a forthright recognition of this logic is that it would require a more fundamental (and more disruptive) reckoning with the fact that "constructive taxes" are embedded in virtually every "charitable" outlay, as well as any other outlay that has the effect of reducing one's federal, state, or local tax obligations.

Part IV discusses legislative options available to Congress to unify the income tax treatment of state and local taxes and charitable contributions under a new provision for "social contributions." By bringing both types of transfers within the same framework, such an approach would confer equivalent treatment on what are, in substance, equivalent transfers, thereby eliminating any residual incentive to recharacterize outlays as falling under one category or the other.

Finally, Part V concludes with a brief commentary on the cognate nature of "taxation" and "gifts," highlighting the many parallels between the two. A better understanding of the shared purpose and common history of taxation and charitable giving should not only prompt consideration of alternative statutory reforms such as those described in Part IV but also influence public discourse regarding the fundamental nature of transfers made in support of public goods, regardless of the form those transfers take.

I. THE TAX TREATMENT OF TAXES AND CHARITABLE GIFTS

For nearly the entire history of the U.S. income tax, charitable contributions and state and local taxes have been treated the same—i.e., both have been deductible in calculating taxable income.[22] This has not always been the case. In the early years of the federal income tax, from 1913 to 1917, state and local taxes were deductible (as they had been under the Union income tax in operation during the Civil War) but charitable contributions were not.[23] That period came to an end with the passage of the War Income Tax Revenue Act of 1917,[24] whereby Congress first allowed a deduction for charitable contributions.[25] The ostensible rationale for allowing a deduction for charitable gifts was to ensure that the income tax, with its newly increased tax rates to finance the war effort, would not discourage individuals from donating to charities established to promote the federal government's war effort.[26] Thus, from the very outset, the federal subsidy for charitable gifts

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22. I.R.C. §§ 164, 170 (2012).

23. Edward H. Rabin, *Charitable Trusts and Charitable Deductions*, 41 N.Y.U. L. REV. 912, 912 (1966).

24. Ch. 63, 40 Stat. 300, 330 (1917).

25. Vada Waters Lindsey, *The Charitable Contribution Deduction: A Historical Review and a Look to the Future*, 81 NEB. L. REV. 1056, 1061 (2003).

26. 2 Evelyn Brody, *Tax Deduction and Philanthropy*, *in* PHILANTHROPY IN AMERICA, 464, 465 (Dwight F. Burlingame ed., 2004).

seems to have had as a central purpose the promotion of financial support for government spending objectives.

Over the ensuing seven decades, from 1917 to 1987, federal law allowed deductions for both state and local taxes and charitable contributions.[27] The Tax Reform Act of 1986[28] altered this equivalent treatment for a subset of taxpayers. More specifically, the 1986 legislation made state and local taxes nondeductible for purposes of calculating the AMT[29] but continued to allow a deduction for charitable contributions. Thus, for the several million taxpayers subject to the AMT each year, federal law newly disfavored state and local taxes relative to charitable contributions. As will be discussed in greater detail below, this disparate treatment of the two types of outlays under the AMT gave taxpayers an incentive to consider the state tax savings associated with charitable gifts—and thus also gave state and local governments a corresponding incentive to devise tax expenditures to steer charitable contributions to legislative priorities. Over this period, states enacted a wide range of tax credits for contributions to various donees, including government entities, government established funds, and other nonprofit organizations.[30]

Finally, with the enactment of TCJA in December 2017, all taxpayers now face a $10,000 limit on the deductibility of state and local taxes.[31] Significantly, however, because TCJA provided no corresponding limit on the deductibility of charitable contributions, the same incentive AMT taxpayers have faced since 1987 (i.e., to favor charitable gifts with substantial state tax savings) now extends to the roughly 19 million tax units who continue to itemize their deductions under the new law.[32]

Why should any of this matter? If the outlays at issue were wholly distinct—like, say, home mortgage interest and medical expenses—then whether the tax law treats them the same or differently would be of no moment. However, difficulties arise when the law confers

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27. I.R.C. §§ 164(a), 170(a) (1982).

28. Pub. L. No. 99-514, § 56, 100 Stat. 2085, 2322 (1986).

29. *Id.*

30. *See* Pender, *supra* note 17 (demonstrating that states have used tax credits for educational funds); *see also*, Gen. Assemb. 154, 2017 Ga. Laws 526, First Sess. (Ga. 2017) (reflecting government focus on revitalizing rural vacant downtown areas through tax credits).

31. The AMT disallowance rule for SALT remains in place but applies to a substantially smaller number of taxpayers. William M. VanDenburgh et al., *2018 1040-ES Offers Relevant Guidance*, 96 TAXES THE TAX MAG. 21 (Oct. 2018).

32. *Id.* at 29.

inconsistent treatment on items that are, in substance, quite similar. With regard to the three main normative considerations in evaluating tax policy—fairness, efficiency, and administrative simplicity—a strong case can be made against sharply differential tax treatment of substantively similar transfers or transactions.[33]

Do charitable contributions and state and local taxes exhibit such similarities? To be sure, we typically think of these as very different types of outlays. "Taxes" are *mandatory* payments made to *governments*, while "charitable contributions" are *voluntary* transfers made to *nonprofits*. Viewed through this frame, there appear to be important distinctions both as to (1) the nature of the transferee (government versus private nonprofit), and (2) the nature of the transfer (mandatory versus voluntary). But these differences, while certainly important, are not as sharply binary as might first seem to be the case.

Regarding the nature of the transferee, it bears noting that state and local governments are, of course, nonprofit organizations whose activities are, in large measure, charitable in nature. In seeming recognition of the parallels between governments and nonprofits, the statutory definition of the term "charitable contribution" expressly includes contributions or gifts to or for the use of state and local governments.[34] Thus, federal law explicitly envisions allowing a deduction for contributions to or for the use of state and local governments. But even if the statute did not expressly include contributions or gifts to state and local governments, the other major category of qualifying donees under section 170(c) includes organizations "organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes."[35] With the

33. David Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1632 (1999) ("Taxing similar activities differently causes behavioral distortions and unfairness. Moreover, the complex doctrines needed to draw these distinctions make compliance costly. Reformers, therefore, argue that a broad tax base, one that taxes all forms of income equally, is the fairest, most efficient, and most easily administered tax base.").

34. I.R.C. § 170(c)(1) (2012). This provision includes the qualifier that such contributions or gifts must be "for exclusively public purposes." *See* Ellen Aprill, Professor, Loyola Law Sch. L.A., Federal Tax Treatment of States, Political Subdivisions and Their Affiliates, Presentation for the National Tax Association, (Nov. 16, 2018).

35. *Id.* § 170(c)(2)(B); *see also Lessening the Burdens of Government as a Basis for Tax Exemption Under IRC Section 501(c)(3)*, INTERNAL REVENUE SERVICE, https://www.irs.gov/government-entities/lessening-the-burdens-of-government-as-a-basis-for-tax-exemption-under-irc-section-501c3 [https://perma.cc/M8H2-9KRM] (last reviewed June 5, 2019).

exception of the reference to religion, this category of purposes essentially mirrors a broad swath of state and local government activities, including particularly such quintessentially governmental (and quintessentially charitable) activities, such as education, health care, environmental protection, and poverty mitigation. Given their overlapping functions, it should come as no surprise that state and local governments and nonprofit organizations often work in partnership in pursuing these activities.[36]

A review of funding sources for the two types of entities also reveals considerable overlap. State and local governments rely chiefly on own-source tax revenue, user fees, and intergovernmental grants for their funding.[37] Similarly, nonprofits rely on a mix of fees (including 25% from government contracts), charitable contributions (tax subsidized), and government grants (funded by taxation).[38] These similarities suggest that traditional nonprofits and governmental entities are drawing on the same pool of resources to fund a broadly similar array of social investments.

As to the notion that taxes are "mandatory" and charitable contributions are "voluntary," this too is certainly true in a formal sense. At first blush, most people would likely agree that "taxes" and "gifts" are very different things. After all, legal sanctions typically apply to those who fail to pay their taxes, while gifts to charity are ordinarily made at the discretion of the donor. Few would deny that those are clear and important differences between the two types of outlays. On the other hand, there is an important element of voluntary choice in taxation, particularly in the state and local setting. Individuals voluntarily opt into state and local fiscal arrangements by virtue of their residential decisions and often do so, at least in part, because of preferences regarding the degree of income redistribution

36. *See, e.g.*, Sarah L. Pettijohn, *Nonprofits and Governments: A Mutually Dependent Relationship*, URB. WIRE: NONPROFITS & PHILANTHROPY (June 10, 2013), https://www.urban.org/urban-wire/nonprofits-and-governments-mutually-dependent-relationship [https://perma.cc/MY6V-CB7K] ("While nonprofits are dependent upon the public sector for funding, the government is dependent on the nonprofit sector to provide services to its constituents.").

37. U.S. Census Bureau, *Quarterly Summary of State & Local Tax Revenue for 2017: Q3* 1, 2 (2017).

38. BRICE S. MCKEEVER, URB. INST., THE NONPROFIT SECTOR IN BRIEF 2015: PUBLIC CHARITIES, GIVING, AND VOLUNTEERING 1, 5 fig. 2 (Oct. 2015).

undertaken by those governments.[39] It is also the case that state and local governments typically undertake social/charitable spending *at the behest of* their voters, including (very commonly) support from those who stand to be net contributors to a system of local public goods provision.[40] A vote to increase one's own taxes to fund some charitable undertaking is not identical to a decision to make a charitable gift, but neither is it something altogether distinct. In both cases, the individual is willingly surrendering private resources for some broader public good. Thus, while it is no doubt true that taxes are "mandatory" in a formal legal sense, it is also true that they arise and persist out of a collective charitable impulse to invest in public goods in much the same way as do voluntary contributions to nonprofits.

As to the "voluntary" nature of charitable contributions, once again this is undoubtedly true in the formal sense of there being no enforceable legal obligation to make any particular contribution to any particular nonprofit organization. Nevertheless, few would dispute that lurking behind that formal truism is a more complicated picture regarding the motives of those who make charitable gifts. Those who suspect that there may be more to the story than pure altruistic impulses would not be surprised to learn that there is a substantial academic literature investigating this precise question.[41] While caution is always warranted in making broad generalizations about diverse human behavior, it seems to be unmistakably true that individuals make charitable gifts for a wide range of complicated reasons—sometimes out of desire to help those in need, perhaps because of social pressure, or at times to signal wealth or secure influence.[42]

Beyond these general points about the many parallels between taxation and charitable giving, one might further note that these two

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39. Mark V. Pauly, *Income Redistribution as a Local Public Good*, 2 J. PUB. ECON. 35–36 (1973); Charles Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 419 (1956).

40. *See, e.g.*, *Los Angeles, California, Homelessness Reduction and Prevention Housing, and Facilities Bond Issue, Measure HHH*, BALLOTPEDIA (Nov. 2016), https://ballotpedia.org/Los_Angeles,_California,_Homelessness_Reduction_and_Prevention_Housing,_and_Facilities_Bond_Issue,_Measure_HHH_(November_2016) [https://perma.cc/JP8Q-RWNU] (ballot measure increasing property taxes to "provide safe, clean affordable housing for the homeless . . ." approved by 77.14% of voters).

41. For a summary of some of the academic work on this question, see Lise Vesterlund, *Why Do People Give?*, *in* THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 568 (Walter W. Powell & Richard Steinberg eds., 2006).

42. *Id.* at 571–72; Laurie E. Paarlberg et al., *The Politics of Donations: Are Red Counties More Donative Than Blue Counties?* 48 NONPROFIT & VOLUNTARY SECTOR Q. 283, 284 (2018).

forms of outlays have often been used interchangeably in funding public goods. Over the span of human history, societies have relied on both forms (sometimes without even regarding them as "different" forms) as methods for pooling resources for social investments and other collective undertakings.[43] Through the centuries, distinctions between "private" and "public" were often non-existent,[44] rendering futile any attempt to label transfers funding collective activities as "taxes" or "gifts." Of course, none of this is to suggest that taxes and gifts are identical in every respect or that there are no meaningful differences between the two. Rather, the point here is to emphasize that these two types of outlays represent complementary and

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43. As an example, consider the funding of Athenian warships via the liturgical system and the *antidosis* procedure, described by Rob Reich in his recent book, JUST GIVING: WHY PHILANTHROPY IS FAILING DEMOCRACY AND HOW IT CAN DO BETTER 31–33 (2018). As Reich explains, the funding would sometimes be provided voluntarily by wealthy individuals, but in the absence of volunteers might also be assigned to a specific wealthy individual, who would then either provide the funding himself or resist the obligation by identifying a replacement donor that he believed to be wealthier and thus better positioned to afford the required contribution. If the replacement donor refused the transfer, the initial appointee would then have the right to offer to exchange estates with the replacement donor. The replacement donor could either accept this offer or, if he refused it, the matter would be referred to a court and jury for resolution. Since this funding system involved, as Reich notes, "elements of voluntarism and compulsion," it provides a useful illustration of the sometimes hazy line between taxation and charitable giving. *Id.* at 32.

44. In Colonial America, for instance, the line between "private" and "public" charitable activities was often blurred owing to the close relationship between church and state during this period. As Hall notes in his treatment of the history of American philanthropy: "Because colonial legal codes did not clearly distinguish between public/private and proprietary/nonproprietary domains, corporations and associations (when they existed at all) served public rather than private purposes [including] maintaining public order and providing education, poor relief, and (in most colonies) religious services." *See* Peter Dobkin Hall, *A Historical Overview of Philanthropy, Voluntary Associations, and Nonprofit Organizations in the United States, 1600-2000*, 32, 33–34, *in* THE NONPROFIT SECTOR: A RESEARCH HANDBOOK (2d ed. 2006); *see also* Michael W. McConnell, *Establishment and Disestablishment at the Founding, Part I: Establishment of Religion*, 44 WILLIAM & MARY L. REV. 2105, 2170–76 (2003) (discussing the role of state churches in discharging civil functions such as poor relief and education, funded via religious taxes). The religious taxes that funded these activities were common in most colonies and continued in some areas well into the 19th century. *See* Carl H. Esbeck, *Dissent and Disestablishment: The Church-State Settlement in the Early American Republic*, 2004 BYU L. REV. 1385, 1458 (2004). Even after religious taxes had been abolished, the Anglican church continued imposing taxes on the general public for a period of years in order to fund its statutory obligation to provide poor relief. See McConnell, *supra*, at 2170–71.

interconnected sources of funding for broadly similar categories of human activities. Thus, we should resist attempts to regard them as fundamentally distinct or as somehow conceptually segregated into separate silos intended for different purposes.

Most intriguingly—and perhaps relevant for understanding the changes introduced by TCJA—different communities rely on a different mix of "taxes" and "charitable contributions," and those differences have an unmistakable political valence. The Republican Party has traditionally emphasized the value of lower taxes and smaller government, putting greater emphasis on voluntary efforts to fund public goods and address societal ills.[45] The Democratic Party, by contrast, has tended to place greater faith in public institutions funded through taxation.[46] It bears noting that these are, of course, broad generalizations and that there are exceptions in history, across communities, and among specific individuals that do not fit these general descriptions. Nevertheless, this portrayal of a partisan divide on the question of how best to fund public goods—through public taxation or through private giving—captures something close to an essential truth about contemporary American politics. In its strongest form, the claim might be phrased as follows: as between two alternative forms of funding public goods, Republicans (generally) favor charitable contributions and Democrats (generally) favor taxation.

Evidence for these generalizations can be observed in state-by-state tax return data on charitable giving and state and local taxes. As a general rule, federal tax returns in "blue states" (understood here as those that supported Hillary Clinton in the 2016 presidential election) featured higher state and local tax deductions than those in "red states" (those that supported Trump in 2016).[47] Conversely, the states with the highest average charitable contribution deductions were more likely to be "red states," while those with lower average deductions were "blue states."[48] For 2016, the last year before the enactment of TCJA in December 2017, the five states with the highest level of state and local

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45. C. Boyden Grey & Elise Passamanni, Opinion, *Here's the Point of 'Points of Light'*, WALL ST. J. (Oct. 2, 2018), https://www.wsj.com/articles/heres-the-point-of-points-of-light-1538433396 [https://perma.cc/EDE8-TNW3] (emphasizing Republican values of reliance on volunteerism and charitable giving as an alternative to government).

46. *See* Paarlberg et al., *supra* note 42, at 285.

47. IRS, IRS TAX STATISTICS, INDIVIDUAL INCOME AND TAX DATA, BY STATE AND SIZE OF ADJUSTED GROSS INCOME Hist. Tbl. 2 (2016).

48. *Id.*

tax deductions were solidly Democratic, while those with the lowest level were predominantly Republican.[49]

Table 1: State/Local Taxes Deducted per Itemizer (2016)

Bold = Supported Clinton in 2016; *Italics = Supported Trump in 2016*

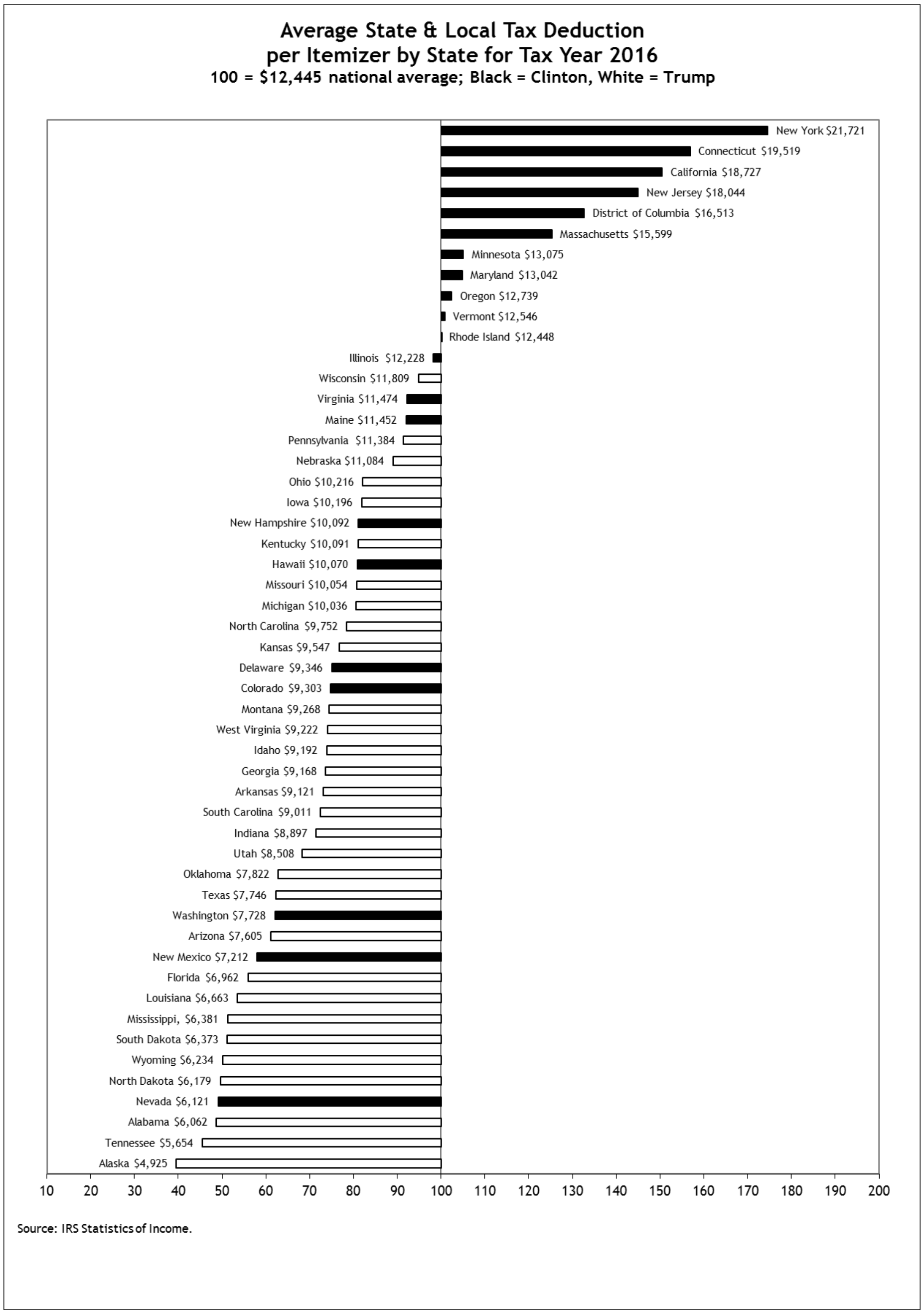
Top Five States	Bottom Five States
1. New York ($21,721)	47. *North Dakota ($6,179)*
2. Connecticut ($19,519)	**48. Nevada ($6,121)**
3. California ($18,727)	49. *Alabama ($6,062)*
4. New Jersey ($18,044)	50. *Tennessee ($5,654)*
5. District of Columbia ($16,513)	51. *Alaska ($4,925)*

Source: IRS Statistics of Income

Data for all fifty states are shown in Figure 1 where states with higher itemized SALT deductions are generally Democratic.[50]

49. *Id.*
50. *Id.*

Figure 1: Average State & Local Tax Deduction per Itemizer by State for Tax Year 2016



By contrast, states with higher levels of charitable contributions per itemizer tend to be Republican and those with lower levels of these deductions are more likely to be Democratic.[51] As shown in the table below, the five states with highest levels of charitable contributions per itemizer are solidly Republican, while states with lower levels tend to be Democratic.[52]

Charitable Contributions Deducted per Itemizer (2016)

Bold = Supported Clinton in 2016; *Italics = Supported Trump in 2016*

Top Five States	Bottom Five States
1. *Wyoming ($9,046)*	47. *Wisconsin ($3,499)*
2. *Arkansas ($8,863)*	48. **Vermont ($3,335)**
3. *Utah ($8,785)*	49. **Hawaii ($3,261)**
4. *South Dakota ($7,829)*	50. **Rhode Island ($2,773)**
5. *Tennessee ($7,195)*	51. **Maine ($2,746)**

Source: IRS Statistics of Income

As with state and local taxes, there are of course exceptions (see Figure 2 on the next page for all fifty states), but again, the tax return data support the generalizations referenced above.

51. *Id.*
52. *Id.*

Figure 2: Average Charitable Contribution Deduction per Itemizer by State for Tax Year 2016

Patterns for charitable giving and taxation seen in the state-level data shown above are also evident in local data. In a recently published study looking at IRS county-level tax return data for the years 2012 and 2013, Paarlberg shows the predicted effect of a county's percentage of Republican voters on state and local taxes and charitable contributions claimed by itemizing taxpayers.[53] Their regressions show that federal itemizers in counties with a higher level of Republican voters will claim higher charitable contributions but a lower level of state and local taxes.[54] Conversely, itemizers in counties with more Democratic voters claim higher deductions for state and local taxes but lower charitable contributions.[55] When these figures are combined to arrive at a "total redistribution" figure, the data show that itemizers in counties with a higher percentage of Republican voters engage in less overall redistribution. As Paarlberg puts it, "[w]hen taking into account the differences in other determinants across Republican-dominant counties and non-Republican-dominant counties (local means), we find total redistribution declines as percent of Republican voters increases."[56] Simply put, Republicans tend to give more to charity than Democrats, but their overall contributions are lower if gifts and taxes are considered together.

Finally, the Paarlberg findings regarding "total redistribution" can be seen in state-level data as well. Combining charitable contributions and state and local taxes for all itemizers in all states, we can see that the total level of "social contributions" is not as bifurcated into distinct red and blue patterns as is the case when each type of outlay is considered separately.[57] Nevertheless, as shown in Figure 3 on page 587, it is generally the case that "blue states" engage in the most "total redistribution."[58] Note, for example, that while New York and Mississippi have roughly comparable levels of charitable giving per itemizer ($5848 and $6034, respectively), the average social contribution for New York itemizers ($27,569) is more than double the level for Mississippi ($12,415). None of this is meant to cast aspersions on different households' giving practices. Rather, the central points

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53. *See* Paarlberg et al., *supra* note 42, at 283–84.

54. *Id.* at 302, Tbl. 7.

55. *Id.*

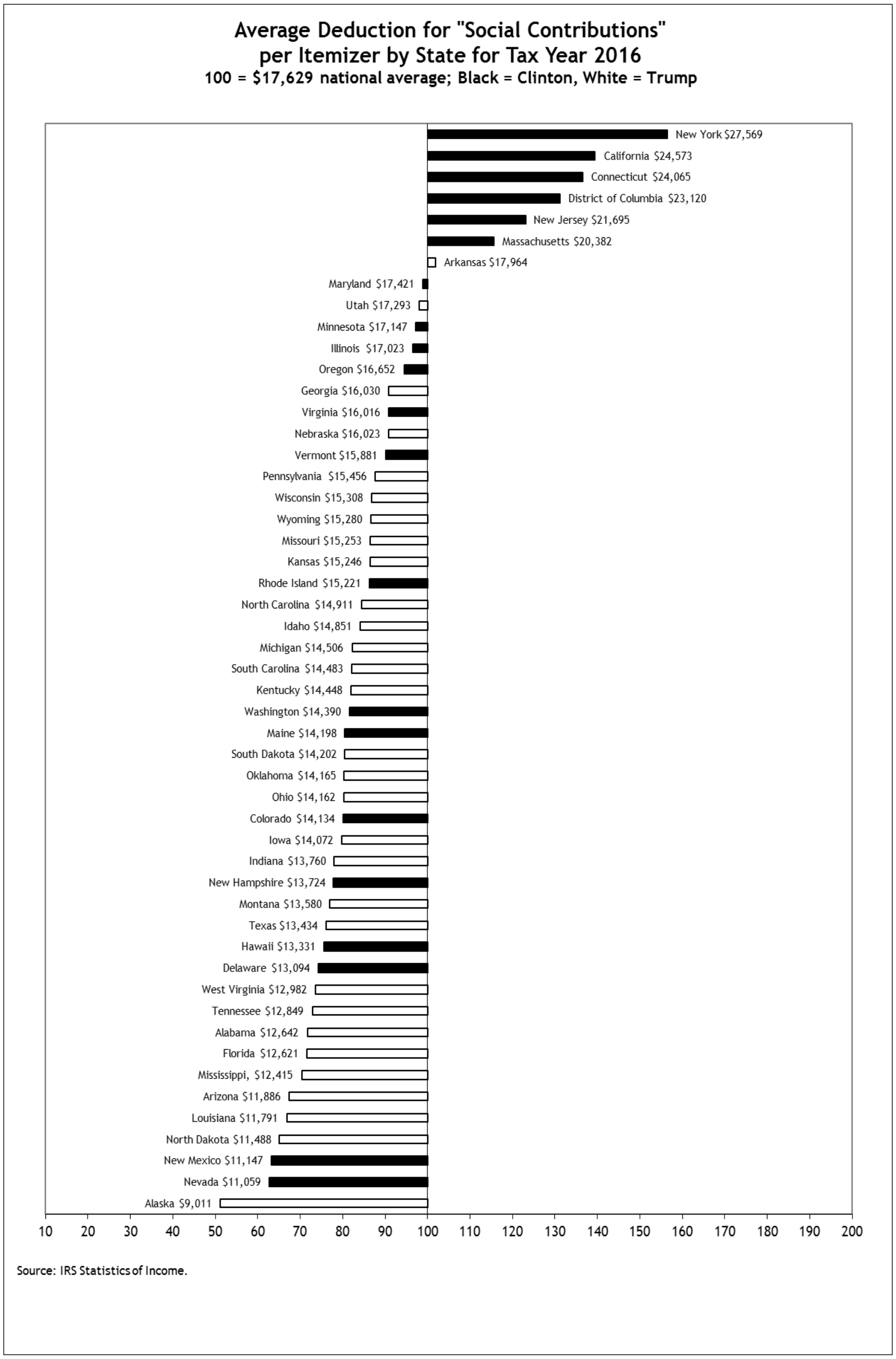
56. *Id.* at 301.

57. IRS, IRS TAX STATISTICS, INDIVIDUAL INCOME AND TAX DATA, BY STATE AND SIZE OF ADJUSTED GROSS INCOME Hist. Tbl. 2 (2016).

58. *Id.*

are that (1) taxation and charitable giving are, in many ways, substitutes, and (2) the composition of overall giving between the two forms varies from state to state, with "blue states" generally favoring more extensive redistribution undertaken more through taxation and less through charitable transfers and "red states" generally favoring less extensive redistribution undertaken less through taxation and more through charitable transfers.

Figure 3: Average Deduction for "Social Contributions" per Itemizer by State for Tax Year 2016



These data provide some political context for the statutory changes introduced via TCJA. That legislation had many different components, some of which, when considered independently, likely would have secured strong bipartisan support, including changes such as the reduction in the corporate tax rate, raising the standard deduction, and doubling the child tax credit. In terms of revenue-increasing provisions, however, the legislation left many with the impression, not wholly unsubstantiated, that Congress intended to "penalize" blue states by capping the SALT deduction at $10,000 while leaving charitable contributions untouched.[59] Indeed, in the wake of TJCA's enactment a group of states challenged the constitutionality of the SALT limiting (via *New York v. Mnuchin*) including references in the complaint to numerous statements from the Treasury Secretary and others regarding the partisan motivation behind the change.[60] While it seems very unlikely that the political animus behind this provision, however explicit, would lead a court to declare the SALT cap unconstitutional, the *New York v. Mnuchin* litigation has brought to light the degree to which Republican lawmakers sought to undermine the "blue state" model of subnational redistribution (higher taxes, lower charitable gifts, higher overall redistribution) in favor of the "red state" model (lower taxes, higher charitable gifts, lower overall redistribution). What Congress seemed not to anticipate, however, despite explicit warnings, was that blue states would make use of a well-worn red state strategy of directing taxpayer resources to state and local legislative priorities through the use of their power not to tax.

II. THE POWER NOT TO TAX

In the analysis above, I have emphasized that taxation and charitable giving ought not be regarded as sharply distinct types of outlays, but rather simply two different forms of accomplishing the same result. Both represent transfers made by individuals in support of public-benefiting activities and social investments. Both arise from some unknown (and likely unknowable) mix of self-regarding and other-regarding motivations. And of course, the ultimate result of both, at

59. *See supra* notes 3–5 and accompanying text.

60. Compl. ¶ 1, New York v. Mnuchin, No. 18 Civ. 6427 (S.D.N.Y., filed Nov. 2, 2018). For further discussion of the states' litigation strategy, see Yancy Roy, *New York, Other States, to Sue IRS over SALT Cap*, NEWSDAY (July 17, 2019, 7:32 PM), https://www.newsday.com/news/nation/cuomo-trump-irs-1.33934624 [https://perma.cc/B6EH-HU5C].

least when done right, is the education of children, the promotion of public health, and the alleviation of human misery in various forms.

Of course, reasonable people can disagree on the extent to which taxation and charitable contributions actually achieve these results, as well as the degree of overlap between them. But whatever distinction there may be between "gifts" and "taxes" falls away completely to the extent that a donor is using a gift to satisfy or reduce her tax liability. There is very little daylight, perhaps even total darkness, between the payment of a "tax" and the reduction of tax brought about by making a legislatively specified "gift." While this is most clearly true when the beneficiary of the gift is a government-specified donee undertaking government-specified activities and the amount of the tax savings derived from making the gift exactly equals the amount of the gift (i.e., a 100% tax credit), it is equally true in the case of any tax-subsidized gift, to any donee, to the extent of the tax savings derived from making the gift.[61]

To illustrate, consider the example offered in the introduction, where $X is transferred from Individual Y to fund some charitable undertaking titled Program Z. This result can be accomplished by "taxation" (whereby Y transfers $X to the government to fund Program Z) or via a "tax-subsidized gift" (whereby the government provides Y with a 100% tax credit for transferring $X to Program Z). In describing these two approaches, one might reasonably wonder what value there is in using two different words. Both accomplish the exact same result—i.e., a transfer of $X by Individual Y to Program Z. Neither is more or less "voluntary" or "mandatory" than the other, and each approach has as much of a claim to being "charitable" as the other.

But for purposes of determining the tax consequences of the transfer, we must nevertheless answer the legal question of whether the tax-subsidized gift should be treated as a "tax" or a "charitable contribution." More precisely, should the outlay be regarded as a payment of tax to the extent that it entitles the donor to a reduction in her tax liability? This is not a new question, but its significance has

61. For example, assume that the government provides a 20% tax credit for transfers up to $10,000 to one's children. What word most accurately captures the essence of this transfer? Is it a gift? Is it a tax? Is it some combination of the two? Or perhaps something else entirely? Assuming A transfers $10,000 to her son and thereby reduces her tax liability by $2000, it is certainly plausible to describe A as having made a gift of $8000 and paid a tax of $2000. The plausibility of this characterization is not diminished by the fact that A's son is not himself a "government." As we will see, this is the approach taken by the Treasury regulations.

come into sharper focus as a result of TCJA's new SALT cap. In addition, as we will see, the recently finalized Treasury regulations adopt a view that is at odds with the approach taken prior to the introduction of the SALT cap.[62]

As a matter of longstanding judicial and administrative interpretations of the rules regarding deductible charitable contributions, the tax benefits of giving (including the tax savings derived from federal income tax deduction itself, as well as a state or local charitable contribution deductions or credits) have traditionally been disregarded in determining the amount of the taxpayer's federal charitable contribution deduction.[63] The effect of this rule has been to treat tax-subsidized gifts as "charitable contributions" under section 170 rather than as "taxes" under section 164 or section 275, despite the fact that the contributions have the effect of reducing the donor's tax liability. I will discuss the legal underpinnings of this "Full Deduction Rule" in further detail below.

The practical effect of this rule is differential tax treatment for the two forms of funding public goods mentioned above: (1) the imposition of conventional taxes, followed by legislative appropriations of public expenditures, and (2) the conditional reduction of tax liability (typically through the provision of an income tax credit) for charitable or public-benefiting outlays made by a taxpayer. Tax policy analysts have long recognized that these two approaches to funding public goods are, in many important respects, fundamentally indistinguishable.[64] In the case of Method 1, the government collects revenue and then appropriates those revenues for legislative priorities. Thus, in the most literal and formal sense, the resources are both transferred from the taxpayer to the government (via tax payments) and then later transferred from the government (via government spending) to those persons or entities carrying out the expenditure functions. Method 2 accomplishes this same result through an alternative form. Under this approach, a baseline level of tax liability is specified by the government, but taxpayers can reduce their tax liability by making outlays that satisfy certain legislative

62. *See infra* Section III.A.

63. *See* BRUCE R. HOPKINS, THE TAX LAW OF CHARITABLE GIVING 80–81 (5th ed. 2014).

64. *See* STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES vii (1973) (claiming that the author introduced "tax expenditures" into modern parlance in a 1967 speech, when he used it to refer to "special exemptions, exclusions, deductions, and other tax benefits" that the government could use to provide financial assistance outside the traditional tax structure).

priorities. In effect, the government spending is carried out by the taxpayer herself (via her qualifying outlay), while her tax payment is satisfied (via a tax deduction, credit, or other device) to the extent of some portion of that outlay.

Note that under Method 1 (i.e., "tax and spend") the government is exercising its "power to tax" while Method 2 (i.e., "tax expenditures") involves the "power *not* to tax" or the conditional reduction of a tax obligation that would be owed had the taxpayer not made the qualifying outlay. Against this conceptual backdrop, we can see the clear effect of TCJA (or any change in federal law limiting the SALT deduction, including the 1986 amendment to the AMT) on state and local government choices regarding how to fund public goods. Method 1 is disfavored because any payment of taxes above $10,000 is treated the same as nondeductible personal consumption, while Method 2 is favored because of the ability of state and local governments to fund public goods through tax subsidies targeted at transfers that qualify as federally deductible charitable contributions.

While most state and local government activities are, not surprisingly, implemented through formal taxation and expenditures, it is nevertheless very common to rely on charitable tax expenditures as a means of implementing subnational legislative priorities. In the weeks preceding the enactment of TCJA, as it became clearer that the final legislation would feature a significant new limitation on the deductibility of state and local taxes, I asked the research librarians at the UCLA School of Law to compile a list of existing state charitable tax credits. This research revealed that, at the time of TCJA's enactment, there were roughly 115 charitable income tax credits in effect in thirty-three states for gifts made to various organizations, including governments, government-established funds, and nonprofits.[65] These tax credits are designed to direct taxpayer resources to a diverse range of government-specified charitable activities, including natural resource

65. *See* BANKMAN, *supra* note 14.

preservation,[66] private school tuition scholarship programs,[67] financial aid for college-bound children from low-income households,[68] public and private rural hospitals,[69] shelters for victims of domestic violence,[70] and numerous other state-supported programs.

By granting a tax credit to donors supporting these programs, the government has chosen to forgo tax revenues that it would otherwise receive in exchange for a donor transferring resources to some state-designated program. The "correct" description of such a program is not self-evident. By forgoing revenue, is the government simply stepping aside—i.e., merely conferring a "lesser tax detriment" by not imposing a tax on the transferor? Or is it instead imposing a de facto tax by allowing the taxpayer to treat her gift as partial satisfaction of a tax that she would have otherwise owed? Both descriptions have a plausible claim to the truth. As explained below, how the law answers this question has important consequences for the federal income tax treatment of the outlay.

A. *Mechanics of State Charitable Tax Credit Programs*

The federal tax mechanics of state charitable tax expenditures can be illustrated by reference to one of the many programs that predate the enactment of TCJA—i.e., the "Exceptional South Carolina Fund," a 501(c)(3) entity established by the South Carolina legislature to receive donations to fund private school tuition scholarships for children with special needs.[71] Assume that taxpayer Jessamine expects to owe $90,000 in South Carolina state income taxes. From 1987 onward, none of this amount would be deductible for Jessamine if she

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66. *See* Jeffrey O. Sundberg, *State Income Tax Credits for Conservation Easements: Do Additional Credits Create Additional Value?* 26 tbl. 1 (Lincoln Inst. Land Pol'y, Working Paper No. WP11JS1, 2011), https://www.lincolninst.edu/sites/default/files pubfiles /1961_1282_sundberg_finalwp11js1.pdf [https://perma.cc/6XFX-Z5DX] (listing state tax credits as of 2011).

67. *See* CARL DAVIS, INST. ON TAX. & ECON. POL'Y, STATE TAX SUBSIDIES FOR PRIVATE K-12 EDUCATION (2016), https://itep.org/wp-content/uploads/k12taxsubsidies.pdf [https://perma.cc/UMP2-BV98].

68. Cal. Assemb. B. 2217, 2017 Assemb., Reg. Sess. (Cal. 2017).

69. H.B. 258, 2017 Gen. Assemb., Reg. Sess. (Ga. 2017).

70. MO. REV. STAT. § 135.550(2) (2019) (Missouri Domestic Violence Shelter Tax Credit).

71. The formal name of the Exceptional SC Fund is the South Carolina Educational Credits for Exceptional Needs Children Fund. The Fund is governed by five directors, two of whom are appointed by the Chairman of the South Carolina House Ways and Means Committee, two by the Chairman of the South Carolina Senate Finance Committee, and one by the Governor.

were subject to the federal AMT. And of course, following the enactment of TCJA, with its new limits on the deductibility of state and local taxes under section 164, only $10,000 of Jessamine's expected state tax liability is deductible, even if she is not subject to the AMT.[72] As noted above, however, there are no comparable limits on the deductibility of charitable contributions under section 170.[73]

Like most states, the state of South Carolina made it possible for its taxpayers to exploit this difference in federal law by providing a 100% state income tax credit for certain charitable gifts.[74] This is a practical, real-world illustration of the types of transfers described above. Rather than raising revenue through taxation and appropriating funds for this purpose, South Carolina exercised its power not to tax those who make charitable donations in accordance with the state's legislative priorities. Thus, under South Carolina law, Jessamine could donate $50,000 to the Exceptional SC Fund, which would entitle her to a nonrefundable tax credit in the same amount when filing her state income tax return. Assuming, for the moment, that the full amount of the donation is respected as a deductible gift (an important assumption, discussed further below), Jessamine's federal return would include a $10,000 deduction for SALT paid and a $50,000 charitable contribution deduction. In sum, rather than facing the possibility of incurring $80,000 in nondeductible state income taxes, Jessamine hopes to preserve $50,000 of that amount, albeit as a charitable contribution rather than a payment of taxes, by making the $50,000 "gift" to the state's 501(c)(3) fund. On its website for the Exceptional SC fund, the South Carolina Department of Revenue advised donors that not only could they "claim a dollar for dollar credit on state income tax liability" but also that they could deduct contributions made to Exceptional SC on their federal income taxes but must "add back the amount of the deduction for South Carolina income tax purposes."[75] Accountants and financial advisors in South Carolina and other states aggressively advertised the federal income tax benefits of programs, such as the Exceptional SC school voucher program.[76]

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72. Tax Cuts and Jobs Act, § 11042(a)(2) (to be codified at I.R.C. § 164(b)(6)(B)).

73. I.R.C. § 170(b) (2012).

74. S.C. CODE ANN. § 12-6-3585(A) (2019).

75. *Exceptional SC*, SOUTH CAROLINA DEP'T OF REVENUE (Nov. 11, 2018), https://dor.sc.gov/exceptional-sc [https://perma.cc/KRH7-UGYW].

76. Carl Davis, *The Other SALT Cap Workaround: Accountants Steer Clients Toward Private K-12 Voucher Tax Credits*, INST. ON TAX'N & ECON. POL'Y (June 27, 2018), https://itep.org/the-other-salt-cap-workaround [https://perma.cc/PXQ6-P3QK].

The post-TCJA charitable tax credits enacted in Connecticut, New Jersey, New York, and Oregon are all structured around these same basic legal principles, though there are some differences as compared to pre-TCJA credits, such as the one in place in South Carolina. First, the tax credits enacted in each of those states are less generous than the 100% credit used in South Carolina and various other states that have adopted school voucher tax credit programs. In New York, for example, the state provides an 85% credit for donation to either of the two state-established funds to provide resources for public education and health care.[77] Thus, one might regard the existing school voucher programs as more aggressive than the more recent post-TCJA state tax credits, at least insofar as the magnitude of the state tax benefit is an element of that determination. Second, in South Carolina the entity qualified to receive creditable donations is a 501(c)(3) organization established and governed by the state legislature, whereas in New York (for example) the charitable funds are "state-operated."[78]

Some commentators have argued that state-operated funds (like those in New York) are "completely different" from situations where a non-governmental fund is merely authorized by the state to receive donations to carry out state-specified functions (like the many pre-TCJA programs that fund private school vouchers).[79] The implication of this argument is that gifts to a state-*operated* fund should not be deductible (because of the credit) while gifts to a state-*specified* fund should be deductible (despite the credit). As noted above, however, Congress has determined that gifts to both state and local governments and non-governmental nonprofit organizations are deductible as charitable contributions.[80] By putting both types of contributions on an equal footing, the plain language of the statute appears to require that they

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77. N.Y. TAX LAW § 606 (McKinney 2019).

78. N.Y. STATE FIN. LAW § 92-gg (McKinney 2019).

79. Jared Walczak, *State Strategies to Preserve SALT Deductions for High-Income Taxpayers: Will They Work?*, 569 TAX FOUND. 5–6 (2018), https://files.taxfoundation.org/20180105094213/Tax-Foundation-FF569.pdf [https://perma.cc/HZ5Y-K3EB] ("A key distinction is that these contributions are not made to the state but to private charities. They do reduce state tax liability, often quite significantly, but they do so by leaving the state treasury worse off rather than making it whole. The contributions in lieu of taxes proposal is completely different."); *see also* Lawrence Zelenak, *SALT Ceiling Workarounds and Tax Shelters*, STATE TAX NOTES, July 23, 2018, at 365, 375 (suggesting that "it is necessary to determine whether a donee is sufficiently identified with the state to trigger the inapplicability of the [Full Deduction Rule]").

80. I.R.C. § 170(c)(1), (c)(2)(B)–(C) (2012).

be treated the same. That is, contributions to both would either be nondeductible (because of the credit) or deductible (despite the credit).[81]

In any event, if it were ever determined that such a formal distinction was somehow relevant despite Congress's clear statement to the contrary, a state could always follow the South Carolina example and establish a separate 501(c)(3) organization to carry out legislatively specified activities. Alternatively, any state or local government could enter into partnership arrangements with select nonprofits to conduct activities consistent with lawmakers' expenditure priorities. The critical point is that section 170 of the Internal Revenue Code, which allows a deduction for charitable contributions, expressly authorizes a deduction for donations directly to state governments and their political subdivisions, and even if it did not include this provision, the various activities encompassed by section 170(c)(2) (e.g., education, health care, poverty relief) essentially mirror the core expenditure functions of state and local governments.[82]

B. The Full Deduction Rule

Of course, the central legal question for Jessamine, as well as donors to any of the more recent funds established in other states, is whether she is in fact entitled to claim a $50,000 charitable contribution deduction for her donation to the Exceptional SC Fund even though

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81. This conclusion is also supported by long-standing IRS guidance, which was cited approvingly by the U.S. Supreme Court in *United States v. American Bar Endowment*, 477 U.S. 106, 117 (1986). *See* Rev. Rul. 67-246, 1967-2 C.B. 104; *see, e.g.*, Ottawa Silica Co. v. United States, 699 F.2d 1124, 1131–32 (Fed. Cir. 1983) (per curiam); Singer Co. v. United States, 449 F.2d 413, 422–23 (Ct. Cl. 1971) ("[P]laintiff would have us decide the case by distinguishing between a *direct* or *indirect* benefit derived. In other words, plaintiff would say that if the transferor received, or expected to receive, benefits from a transfer to a charitable transferee, which benefits were to be received only *indirectly*, then regardless of the magnitude of those benefits, the transfer would still qualify as a charitable contribution deduction under section 170. However, if those same benefits were received, or expected to be received, *directly* from the transferee, plaintiff would concede that, given a substantial *quid pro quo*, the transfer would not come within the definition of a 'gift' or 'contribution' for purposes of deductibility under section 170. Obviously, we cannot agree with plaintiff's distinction.").

82. § 170(c)(2); Frank Sammartino, *How New York State Responded to the SALT Deduction Limit*, TAX POL'Y CTR.: TAXVOX BLOG (May 14, 2018), https://www.taxpolicycenter.org/taxvox/how-new-york-state-responded-salt-deduction-limit [https://perma.cc/9GGJ-6RGF] ("The irony, of course, is that state and local taxes support spending that is at least as much in the public interest as the activities of private charities supported by charitable contributions.").

the outlay entitled her to a $50,000 state tax credit. It is tempting to look at Jessamine's situation and conclude that her $50,000 donation to the Exceptional SC Fund is not a "true" gift deserving of a charitable contribution deduction. For example, one might argue that Jessamine lacks the requisite donative intent to make a charitable gift or that the amount of her deduction should be reduced by the value of the benefits/privileges she accrues (in the form of the tax credit) as a result of making the gift. These are longstanding and familiar principles in the tax law of charitable giving. For better or for worse, however, the tax law has never treated the receipt of federal, state, or local tax benefits that arise from making a gift as evidence that the donor lacked the required donative intent or that some lesser amount should be deducted.[83] This is true despite the fact that the tax benefits of giving have often been quite substantial, especially at particular moments in U.S. history.[84]

This principle of federal tax law—which in separate work with several co-authors I have referred to as the Full Deduction Rule—deserves emphasis here because of its central role in the tax law of charitable giving.[85] Donors derive many tax benefits from making gifts. All of these tax benefits have the effect of reducing the net cost of the gift to the donor, sometimes quite substantially. And yet, taxpayers have never been required to reduce the amount of their charitable contribution deductions by the value of these tax benefits, even where the benefits took the form of a reduction in the taxpayer's nondeductible tax liability. In other words, the amount of a donor's charitable contribution deduction is determined by reference to the gross amount donated (or the fair market value of property donated),

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83. *See* Joseph Bankman et al., *State Responses to Federal Tax Reform: Charitable Tax Credits*, TAX NOTES, Apr. 30, 2018, at 641, 644 (noting that despite a donor benefitting tax-wise by making the donation, current law reinforces this approach known as the "full deduction rule").

84. In 1960, for example, the top combined federal and state marginal tax rate for a California resident was 97.5%, consisting of a 91% federal rate and a 6.5% state income tax rate. For a taxpayer subject to these rates, making a $10,000 deductible gift was virtually indistinguishable from making a $10,000 payment of taxes since a deductible gift would have the effect of reducing the donor's combined federal and state tax liability by $9158.50—i.e., $8508.50 in federal savings ($9100, adjusted to reflect the reduced SALT deduction from the state tax savings derived from making the gift) and $650 in state tax savings.

85. *See* Joseph Bankman et al., *Caveat IRS: Problems with Abandoning the Full Deduction Rule*, STATE TAX NOTES, May 7, 2018, at 547, 547.

reduced by the value of non-tax benefits expected to be received as a result of making the gift (i.e., quid pro quo rule) but not reduced by the federal, state, or local tax savings arising from making the gift (i.e., Full Deduction Rule).[86]

Consider the many ways that donors use charitable gifts as a means of reducing (satisfying?) their tax obligations. First, and most obviously, there is a federal income tax deduction for charitable contributions.[87] This provision reduces the net cost of the gift to the donor by the amount of the gift, multiplied by the donor's federal marginal tax rate.[88] For a donor subject to the top federal marginal rate of 37%, a $10,000 gift provides $3700 in federal tax savings. Federal law has always allowed a deduction for the full $10,000 donated, despite the fact that the deduction results in a $3700 reduction of the donor's otherwise nondeductible federal income taxes.[89] Thus, in effect, the donor here might be described as engaging in a "workaround" strategy that enables her to bypass the law's express nondeductibility of federal income taxes.

Preventing this particular workaround strategy would entail requiring taxpayers to calculate a deductible amount reflecting the fact that the federal income tax is nondeductible. Because the tax benefit takes the form of a deduction, its value is a function of the taxpayer's marginal tax rate. Thus, a taxpayer subject to a 37% marginal tax rate who donates $10,000 would be allowed to deduct only $7299 (i.e., $10,000, multiplied by 1/1.37). Allowing a $7299 deduction for a $10,000 donation would ensure that the federal income tax satisfied by claiming the deduction (i.e., $2701, or $7299 multiplied by .37) will not itself be deducted as part of the charitable contribution. Of course, federal law has never required taxpayers to do this, despite the explicit denial of a deduction for federal income taxes, but the implication of those who argue against the Full Deduction Rule is that all taxpayers should be required to compute their charitable contribution deductions in this manner.[90]

86. *Id.*

87. *Id.* § 170(a)(1). In addition to the benefit of the deduction itself, those who donate appreciated property may also be able to avoid having to recognize gain from the transfer of the property. *Id.* § 170(e)(1)(A).

88. *Id.* § 170(b).

89. *Id.* § 275(a)(1).

90. Some have suggested that requiring donors to reduce the amount of their charitable contribution deductions by the value of the federal deduction itself would

Second, the donor may also be entitled to a state income tax deduction for the gift. In California, for example, this could mean additional income tax savings equal to the amount of gift, multiplied by 13.3%—or another $1330 on top of the $3700 in federal tax savings.[91] In combination, the federal and state income tax deductions, at least for donors in California, could potentially cut the net cost of the gift to the donor in half. That is, despite making an outlay of $10,000, the net cost of that transfer is only $4970. Again, using an algebraic formula, it is possible to calculate an alternative deductible amount that backs out the combined effect of the federal and state tax savings. However, now this formula must account for the interaction of federal and state law, particularly whether the value of the state deduction is a function of the federal deduction (as would be the case, for example, where state taxable income is determined by reference to federal taxable income).[92]

Beyond the federal and state tax savings derived from charitable contribution deductions, many states also provide income (or other) tax credits to encourage charitable giving.[93] These credits also reduce the net cost of the gift to the donor and thus, in the absence of the Full Deduction Rule, would be backed out of the amount of the charitable

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be contrary to the purpose of having a charitable contribution deduction in the first place. *See, e.g.*, David Kamin, *Treasury's SALT Regulations: Fixing What They Can*, MEDIUM (Sept. 4, 2018), https://medium.com/whatever-source-derived/treasurys-salt-regulations-9a7e121531ce [https://perma.cc/NK9D-H2UG] ("Sure, there's a tax benefit from the federal government, but that's the very idea—the federal government, for better or worse, wants to encourage this kind of giving and so is subsidizing it."). As shown in the text, however, the result of taking account of the value of the deduction is not to deny a charitable contribution deduction altogether (which would of course defeat the purpose of having such a deduction) but rather simply to reduce the amount of the deduction to take account of the value of the federal tax savings. Thus, rather than frustrating congressional intent, performing this adjustment would serve the dual function of advancing the purposes of both § 170(a)(1) (allowing a charitable contribution deduction) and § 275(a)(1) (disallowing a deduction for federal income taxes). As we will see, this is the apparent goal of the recently finalized IRS regulations with regard to state and local tax credits—i.e., to advance the purposes of both § 170 and § 164(b)(6). If the notion is to simultaneously implement both provisions, this same logic would seem to apply to the value of the federal deduction as well.

91. CAL. REV. & TAX. CODE § 17041(a)(1) (West 2011); *California Personal Income Tax Laws*, FINDLAW (2019), https://statelaws.findlaw.com/california-law/california-personal-income-tax-laws.html [https://perma.cc/T2QM-NZB2].

92. *See* Bankman et al., *supra* note 85, at 551.

93. *See, e.g.*, 22 VA. ADMIN. CODE § 40-41-50 (2019).

contribution that a donor is allowed to deduct. This would mean that Jessamine would not be entitled to any charitable contribution deduction for her contribution to the Exceptional SC Fund. Where the value of the tax credit is less than 100%, the amount of the charitable contribution deduction would be reduced by the value of the credit. Thus, a donor making a $10,000 contribution that entitles her to a state charitable tax credit of 40% would have to reduce her deduction by $4000. As explained in further detail below, this is essentially the approach that the IRS has taken in the regulations finalized in June 2019.[94]

While the operation of the Full Deduction Rule only became the subject of debate in the course of the post-TCJA controversy over the SALT cap, its role in the tax law of charitable giving is nevertheless quite familiar. Anyone who has ever claimed a charitable contribution deduction on Schedule A of Form 1040 has applied this rule, whether they knew it or not, in filing their return. In some cases, the application of the Full Deduction Rule had no effect on the donor's federal income tax liability. For example, where a gift reduces a state or local tax obligation that would have been deductible, then the allowance of a charitable contribution deduction for the full amount of the gift, undiminished by the tax savings, simply shifts the deduction from 164 to 170 and thus a different line on Schedule A. In other cases, however, the Full Deduction Rule has had the effect of allowing the taxpayer to claim a charitable contribution deduction for outlays that reduce her nondeductible tax obligations. This is true, for example, with regard to any federal tax savings (nondeductible by virtue of section 275(a)(1)) as well as any state or local tax savings for AMT taxpayers (nondeductible from 1986 onward by virtue of section 56(b)(1)(A)(ii)).

By further limiting the deductibility of state and local taxes, not just for AMT taxpayers for all itemizers, the 2017 legislation broadened the population of taxpayers for whom the Full Deduction Rule provides a federal tax advantage. It appears that Congress did not consider these effects in its consideration of TCJA. Once the new law took effect, however, it became apparent that the SALT cap's interaction with the Full Deduction Rule could potentially result in several hundred billion dollars of lost revenue that Congress had hoped the SALT cap would raise. Preserving the expected revenue increase would require a rejection of the Full Deduction Rule through administrative regulations.

94. *Infra* Section III.A.

III. TREASURY REGULATIONS AND CONSTRUCTIVE TAXES

We have now reached the crux of the current controversy, but the analysis above has revealed various complications. Some of these complications are conceptual, others legal and practical. Before addressing those complications, however, it is useful to briefly describe the approach that the Treasury Department has recently taken regarding the continued role of the Full Deduction Rule.

A. *Treasury Regulations Regarding State Charitable Tax Credits*

On August 27, 2018, the Treasury Department issued proposed regulations under section 170 concerning "Contributions in Exchange for State or Local Tax Credits."[95] These regulations were issued in final form—with only minor modifications—in June 2019.[96] The supplementary information included in the regulations provides an extremely useful summary of the background and basic issues involved. The regulations themselves are quite brief. Most significantly, the regulations specify that "if a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c), the amount of the taxpayer's charitable contribution deduction under section 170(a) is reduced by the amount of any state or local tax credit that the taxpayer receives or expects to receive in consideration for the taxpayer's payment or transfer."[97] In effect, the approach adopted here is to treat the value of any state or local tax credit as a "return benefit" or "quid pro quo." Thus, in the same way that a donor who gives $100 to NPR, receiving a $30 tote bag in return, may only deduct $70, so too must a taxpayer who makes any gift generating a state or local tax credit reduce the amount of her charitable contribution deduction by the value of the credit.

The logic underlying this approach is not hard to understand. In effect, the donation to NPR is bifurcated into two components: (1) a $70 deductible gift and (2) a $30 nondeductible purchase of a tote bag. Similarly, if a taxpayer makes a $100 gift that entitles her to a $30 state tax credit, one can imagine treating the taxpayer as having made (1) a $70 deductible gift and (2) a $30 nondeductible state tax payment. The

95. Contributions in Exchange for State or Local Tax Credits, 83 Fed. Reg. 43,563 (proposed Aug. 27, 2018) (to be codified at 26 C.F.R. pt. 1).
96. Contributions in Exchange for State or Local Tax Credits, 84 Fed. Reg. 27,513 (June 13, 2019) (to be codified at 26 C.F.R. pt. 1).
97. 26 C.F.R. § 1.170A-1(h)(3) (2019).

regulations very plainly provide for the first component of this bifurcated treatment (i.e., the reduced deduction), but they stop short of explicitly endorsing the second component. I will say more about that dimension of the analysis below.

The regulations provide two important exceptions to the general rule just described—as well as one additional "exception" that arises by virtue of the scope of the general rule. First, the regulations specify that a "taxpayer is not required to reduce its charitable contribution deduction under section 170(a) on account of [any] state or local tax *deductions*."[98] In other words, the regulations apply only to credits, not to deductions. This exception seems to be a concession to administrative simplicity. Requiring taxpayers to reduce the amount of their federal charitable contribution deductions by the value of state tax deductions would entail considerable complexity. To determine the amount by which the federal deduction would need to be reduced, taxpayers would have to know their state marginal tax rate, which itself is likely to be a function of the availability and amount of the deduction. It seems likely that the IRS wanted to spare taxpayers the burden of making these circuitous calculations. But, of course, not extending the regulations to deductions leaves open a "mini-workaround" opportunity. In effect, the taxpayer is satisfying a portion of her state tax liability by claiming the state tax deduction. By allowing her nevertheless to claim an undiminished federal charitable contribution deduction despite those state tax savings, the regulations are green lighting a de facto deduction for state taxes to the extent of the state tax savings. It is possible that the IRS regarded the effects of this lingering workaround as de minimis.

The second exception is related to the first. In addition to ignoring deductions, the regulations provide a safe harbor for state tax credits of 15% or less by noting that the general rule "shall not apply to any payment or transfer of property if the total amount of the state and local tax credits received or expected to be received by the taxpayer is 15 percent or less of the taxpayer's payment, or 15 percent or less of the fair market value of the property transferred by the taxpayer."[99] This safe harbor for credits of 15% or less appears to represent a recognition that credits and deductions have the same effect and that state and local governments should not have to adhere to the form of

98. *Id.* § 1.170A-1(h)(3)(ii) (emphasis added).
99. *Id.* § 1.170A-1(h)(3)(vi).

a deduction to fit within the de minimis rule. The official summary of the regulations notes that the 15% figure was chosen to reflect the current maximum state and local income tax rate.[100] Thus, the implication would seem to be that taxpayers claiming a federal charitable contribution deduction may ignore either the value of any state tax deduction or the value of a credit of 15% or less, but not both. How this rule will be operationalized in practice is not obvious in every case. For example, if a local government provides a 15% credit against local property tax liability for gifts to some local charity, donors might take the view that the credit exception allows them to claim a full charitable contribution deduction for the gift since the credit satisfies the 15% threshold. If state law also allows an income tax deduction for the gift, must the taxpayer reduce her federal charitable contribution by the value of the state tax savings derived from making the gift?[101] The regulations do not directly address this scenario.

Beyond these two explicit exceptions, there is a third exception that is not mentioned in the regulations but applies by implication—i.e., an exception for the tax savings derived from the federal charitable contribution deduction itself. There is a conceptual puzzle at the heart of the disparate approach taken by the regulations for state and local tax credits (where the Full Deduction Rule is abandoned) and the federal tax deduction (where the Full Deduction Rule continues to apply). A more in-depth consideration of this puzzle may shed some light on the choices we are making by adopting these rules.

Consider once again the basic rationale for requiring a donor to reduce the amount of her $10,000 charitable contribution deduction by the $4000 state tax credit—i.e., allowing a $10,000 deduction would enable her to avoid the nondeductibility of $4000 of her state tax liability. Because the law now treats the satisfaction of taxpayer's state tax liability as a form of nondeductible personal consumption, the regulations apply the same treatment for state tax credits received in exchange for a gift as would apply in the case of a tote bag received in exchange for a gift. The reduction in the amount allowed as a charitable contribution is necessary, so the argument goes, because not

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100. *See* Contributions in Exchange for State or Local Tax Credits, 83 Fed. Reg. at 43,565 ("The 15-percent exception is intended to reflect the combined benefit of state and local tax deductions, that is, the combined top marginal state and local tax rates, which the Treasury Department and the IRS understand currently do not exceed 15 percent.").

101. The example in the text involves the simultaneous application of the exceptions found in paragraphs (ii) and (vi) of § 1.170A-1(h)(3).

doing so would allow the taxpayer to smuggle some nondeductible expense into her charitable contribution deduction.

But of course, this very same rationale applies to *any* federal, state, or local tax liability that is reduced by virtue of making a charitable gift, including the federal income tax deduction itself. To understand this point, it important to keep in mind that just as state and local taxes in excess of $10,000 are nondeductible by virtue of section 164(b)(6), all federal income taxes are nondeductible by virtue of section 275(a)(1). Thus, if the object of applying the quid pro quo logic to state tax credits is to prevent taxpayers from smuggling nondeductible tax payments into their deductible charitable contributions, then it would seem that the same rule should apply to all nondeductible taxes, whether state, local, or federal.

The IRS may be reluctant to open this particular can of worms, given the many administrative complexities associated with requiring donors to treat the value of the federal deduction itself as a benefit requiring a reduction in the amount of the taxpayer's deduction. As a conceptual matter, however, it is hard to escape the conclusion that the treatment of state and local tax benefits in calculating one's charitable contribution deduction is tied to the fate of the federal tax benefits. The same logic that supports treating a reduction in the taxpayer's state and local tax liability as a return benefit (i.e., to that extent, she is not making a gift but deriving a personal benefit in the form of state/local tax savings) applies with equal force in the case of any reduction in the taxpayer's nondeductible federal tax liability (i.e., to that extent, she is not making a gift but deriving a personal benefit in the form of federal tax savings). Put differently, one might note that, to the extent of any tax savings derived from making a charitable gift, the donor is not acting "charitably" but rather merely satisfying an obligatory tax. If that is the logic behind the regulations, then it follows that the donor's charitable contribution deduction should be reduced by the value of *all* tax savings, not just those arising from state tax credits.[102]

Thus, at bottom, the regulations do not represent a repudiation of the Full Deduction Rule but rather a narrowly tailored limitation on its operation. That is, the Full Deduction Rule is rejected for state and local tax credits in excess of 15%, but it is retained for all other tax benefits (i.e., federal and state deductions, as well as all state credits

102. For an alternative view, see Lawrence Zelenak, *SALT Ceiling Workarounds and Tax Shelters*, TAX NOTES, July 23, 2018, at 521, 532–33.

below 15%).[103] The lack of precedent for such a change in the law is noteworthy. In previous research on this topic, we have been unable to identify a single instance where a taxpayer was required to reduce the amount of her charitable contribution deduction by the value of the tax benefits arising from making a charitable gift. What legal authority there is on the subject—from the Tax Court, the 4th Circuit, the 10th Circuit, and the IRS itself—supports the Full Deduction Rule.[104] These holdings generally ignore the tax effects of making a charitable contribution in determining the amount of the federal deduction. Significantly, this approach is also consistent with the federal income tax treatment of nonrefundable tax credits in a variety of other settings.[105]

While the regulations mark a change of direction in the law, it is likely that a federal court will have the final say on this matter.[106] While courts often (appropriately) defer to administrative interpretations of a statute, that deference is not automatic and universal. To be sure, the IRS is on firmer ground by having taken the approach of issuing regulations via a notice-and-comment procedure rather than through alternative subregulatory means.[107] Nevertheless, given the sharp departure from a century's worth of law and practice, the validity of these regulations is a proper subject of federal litigation.

Is there a valid justification for this departure from existing case law? Some commentators have suggested that the introduction of the new SALT cap constitutes a change in the law so significant that it warrants a wholesale reconsideration of pre-TCJA case law. For example, Roger Colinvaux has argued that the Full Deduction Rule should be understood "against a legal baseline of deductible state tax payments" and that TCJA "fundamentally changed the law by substantially

103. 26 C.F.R. § 1.170A-1(h)(3)(vi).

104. *See* Bankman et al., *supra* note 83, at 641–42 (outlining the precedent and policy supporting the Full Deduction Rule).

105. Alan L. Feld, *Federal Taxation of State Tax Credits*, TAX NOTES, May 30, 2016, at 1, 2 (noting that "both the IRS and the courts have excluded from income the receipt of nonrefundable credits that reduce state income tax liability").

106. Nick Niedzwiadek & Katherine Landergan, *New Jersey, New York Sue to Challenge IRS' SALT Workaround Rule*, POLITICO (July 17, 2019) https://www.politico.com/states/new-york/albany/story/2019/07/17/new-jersey-new-york-sue-to-challenge-irs-salt-workaround-rule-1107484 [https://perma.cc/2MV7-8VU3].

107. Peter H. Schuck & E. Donald Elliot, *To the Chevron Station: An Empirical Study of Federal Administrative Law* 1990 DUKE L.J. 984, 1010 (1990).

limiting the deductibility of state and local tax payments."[108] This is a reasonable perspective; however, state and local taxes have been nondeductible for AMT taxpayers since 1987, meaning that the Full Deduction Rule has coexisted with nondeductible state and local taxes for thirty-plus years. Moreover, federal income taxes have (almost) always been nondeductible, and yet the amount of the taxpayer's charitable contribution deduction has always been the amount of cash or fair market value of property donated, undiminished by the federal tax savings derived from the gift.[109] These considerations militate against the view that TCJA ushered in a new legal baseline of nondeductible taxes that would justify repudiating the Full Deduction Rule for post-TCJA transfers.

Another question that some commentators have raised relates to the application of the regulations to donations to organizations other than state or local governments.[110] The general argument is that the current regulations relating to quid pro quo transfers apply only to benefits received directly from the donee. Thus, benefits received from a third party (in the case of tax benefits, the third party being the government) do not implicate the quid pro quo regulations. By applying the new rule to transfers involving any donee described in section 170(c), not just government donees, the IRS has rejected this argument. That is, the regulations treat the state and local tax benefits derived from making a gift to the State of New York the same as the state and local tax benefits from making a gift to, say, the United Way or the Exceptional SC Fund discussed above.

This point, which I have emphasized in my own writing on the subject, flows from a straightforward application of section 170(c), which provides no basis for differentiating between gifts to governments and other nonprofits.[111] Moreover, as Roger Colinvaux has emphasized in his writing on the subject, it is a well-settled principle in this area of law that direct and indirect benefits arising from the transfer are to be treated the same—or, as Colinvaux puts it, "the relevant benefits do not have to come directly from the charity but

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108. Roger Colinvaux, *Failed Charity: Taking State Tax Benefits into Account for Purposes of the Charitable Deduction*, 66 BUFF. L. REV. 779, 816 (2018).

109. For a discussion of the history of the switch of the federal income tax from a tax-exclusive to a tax-inclusive base, see LAWRENCE ZELENAK, FIGURING OUT THE TAX: CONGRESS, TREASURY, AND THE DESIGN OF THE EARLY MODERN INCOME TAX 64–66 (2018).

110. Zelenak, *supra* note 79, at 375; Grewal, *supra* note 19, at 242–43.

111. *See* Bankman, *supra* note 83, at 644.

rather flow from the transfer."[112] It is because of this legal principle that the fates of the "red state" programs (tax credits for transfers to private schools) and "blue state" programs (tax credits for transfers to government funds) are linked. In each case, the donor is receiving the identical thing—i.e., a state tax credit—the only difference is that in one case, the qualifying donee is described in section 170(c)(1), and in the other, it is described in section 170(c)(2).

B. *Toward a Jurisprudence of "Constructive Taxation"?*

One clear but unstated implication of the regulations is that a donor who makes a charitable contribution where she receives or expects to receive a state or local tax credit is making a de facto payment to the extent of the tax savings derived from the outlay. Interestingly, in an earlier Chief Counsel Advisory on this issue (where it was concluded that state tax credits generally do not constitute a quid pro quo), it was noted 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*."[113] While the regulations now treat state tax credits as a quid pro quo, they do not take this final step of recharacterizing the payment as "in substance, a satisfaction of tax liability."[114] Of course, the explicitly stated reason for reducing the taxpayer's charitable contribution deduction is that the disallowed portion represents, in substance, the satisfaction of a state or local tax liability. It would seem to follow from that position that the disallowed portion represents a "constructive tax."

In the notice-and-comment period for the proposed regulations, the IRS received numerous comments drawing attention to this feature of the regulations.[115] Of particular concern were those situations involving itemizing taxpayers with aggregate state and local tax liability under the $10,000 cap. Some argued that these individuals would be treated unfairly by the regulations in that they would neither be able to claim a charitable

112. Colinvaux, *supra* note 108, at 792.; *see also* Rev. Rul. 67-246, 1967-2 C.B. 104 (Example 11) (providing a hypothetical in which the amount of the charitable contribution deduction was reduced by the value of a transitor radio transferred to donor in exchange for a gift to charity, even though the transistor radio came from a department store, not from the charity).

113. I.R.S., Office of Chief Counsel, Advisory 201105010 (Feb. 4, 2011), at 4 (emphasis added).

114. *Id.*

115. Contributions in Exchange for State or Local Tax Credits, 84 Fed. Reg. at 27,515.

contribution deduction (because of the regulations) nor a state and local tax deduction (because their tax liability had been reduced by the credit).[116] Treating a payment giving rise to a state tax credit as a "constructive tax" would seem to be the natural solution.

The IRS may be reluctant to embrace this conclusion—and understandably so. Characterizing a portion of an outlay made by choice as a constructive tax would mark a significant departure from current law and practice. For example, consider the IRS Notice issued in late December 2017 regarding the "prepayment" of property taxes.[117] Since 2017 was the last year in which state and local taxes were not capped at $10,000, many taxpayers hoped to bunch their property taxes into 2017 by preparing some or all of their property taxes for 2018 or future years. In taking the position that such payments would not be deductible as taxes, the IRS Notice observed that "[s]tate or local law determines whether and when a property tax is assessed, which is generally when the taxpayer becomes liable for the property tax imposed."[118] Treating a donor's payment as a constructive tax would represent a departure from this position.

More fundamentally, the concept that the receipt of state or local tax benefits should be treated as a constructive payment of the taxes reduced has far broader potential implications well beyond the domain of charitable contributions. If a contribution to a school tuition organization that produces a state tax credit is treated as a de facto satisfaction of tax liability, then the same logic would seem to suggest that a payment of interest to one's home mortgage lender should also constitute a payment of tax to the extent that such payment has the effect of reducing the payor's tax liability. Countless other situations involving the receipt of state or local tax benefits would likewise seem to be implicated. For example, Minnesota provides a nonrefundable state income tax credit for past military service.[119] Massachusetts provides a nonrefundable state income tax credit to certain individuals over age sixty-five who have paid property taxes or rent.[120] And of course, numerous states offer tax credits for a wide range of activities, such as historic preservation, environmental remediation, and economic

116. *Id.* at 27,519.

117. I.R.S. Advisory: Prepaid Real Property Taxes May Be Deductible in 2017 if Assessed and Paid in 2017, IR-2017-210 (Dec. 27, 2017).

118. *Id.*

119. MINN. STAT. § 290.0677(1a) (2019).

120. MASS. GEN. LAWS ch. 62, § 6(k)(2) (2019).

development.[121] In each case, the federal income tax treatment of these credits is premised upon the same basic legal principle that the regulations have now repudiated in the context of state charitable tax credits.

In some ways, developing a set of rules for "constructive taxes" is simply the next logical step after the regulations. Tax policy analysts have long recognized that tax expenditures entail both a "constructive tax" and a "constructive expenditure." That is, to subsidize some activity or payment via reduced taxes is the substantive equivalent of collecting a tax and appropriating the resulting revenue. Perhaps the most entertaining explanation of this tax expenditure concept is the "weapons supply tax credit" (WSTC) described by the late David Bradford in a wonderful essay on budgetary language.[122] Bradford proposed (tongue in cheek) to eliminate all federal spending on weapons procurement and instead enact a new tax credit that weapons manufacturers could claim upon delivery of statutorily specified weapons systems to the Department of Defense. The result of these two steps is that both government spending and tax receipts would decline substantially—but of course, as Bradford explained, "the economic reality would be unaffected."[123]

If we take seriously this tax expenditure mode of analysis, the implication would be that every time a taxpayer satisfies a portion of her tax burden by making an outlay that qualifies for some tax expenditure, a portion of that outlay "actually" (or "in reality" or "in substance") represents a payment of tax. In other words, the taxpayer is, in effect, satisfying a portion of her tax burden by making a qualifying expenditure.

C. The Paradox of Charitable Taxes and Non-Charitable Gifts

Although the Treasury regulations were finalized in June 2019, ostensibly addressing the most pressing legal questions (pending the litigation challenging the regulations referenced above), we are still left with a perplexing irony regarding the new federal income tax treatment of state and local taxes as compared to charitable contributions. Two otherwise identical payments made to fund some

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121. *See, e.g.*, CAL. REV. & TAX. CODE § 24369.4 (West 2019) (environmental remediation tax credit); IND. CODE § 6-3.1-13-14 (2019) (economic development tax credit); VA. CODE ANN. § 58.1-339.2 (2019) (historic preservation tax credit).

122. David F. Bradford, *Reforming Budgetary Language*, *in* PUBLIC FINANCE AND PUBLIC POLICY IN THE NEW CENTURY 93 (Sijbren Cnossen & Hans-Verner Sinn eds., 2003).

123. *Id.* at 98.

public good will be treated differently simply because one of them takes the form of a charitable contribution, and the other is paid for via taxation. For example, assume two taxpayers, A and B, both of whom are subject to the top federal rate of 37% and both of whom have already paid the maximum amount deductible state and local taxes. Taxpayer A transfers $10,000 to a nonprofit organization to help fund the operation of a local homeless shelter. Taxpayer B pays $10,000 in taxes to her local government to help fund the operation of a homeless shelter. We might assume that Taxpayer A resides in a "red state" with relatively few government-provided services to address homelessness, while Taxpayer B resides in a "blue state" with greater tax-funded government spending on homelessness.

The effect of the SALT cap introduced by TCJA is that Taxpayer A has 37% of the cost of her $10,000 outlay reimbursed to her by virtue of the deduction available under section 170(a), while Taxpayer B faces a $10,000 out-of-pocket cost. Thus, paradoxically, it is Taxpayer B who is the more "charitable" of the two transferors—at least insofar as we measure "charitable" by reference to degree of actual financial sacrifice experienced by the transferor. Of course this is precisely the intended result of the SALT cap—i.e., to treat all outlays taking the *form* of a state or local tax payment as a type of personal consumption and thus nondeductible in the same manner as the most self-indulgent conspicuous consumption, such as a Reinast titanium toothbrush ($4200) or a Hang Fung golden toilet ($5 million).[124]

Whatever appeal this view may have in certain political quarters, state and local tax payments have far more in common with charitable contributions than with personal consumption, particularly for the cohort of itemizing taxpayers who are most likely to be net contributors to state and local public goods rather than net recipients. Thus, the result of the SALT cap is the introduction of a new horizontal inequity in the law, one that favors charitable outlays undertaken outside the public sector as compared to those undertaken within the public sector. In this sense, the SALT cap is similar in effect to various other anti-government/anti-tax measures introduced in the United States over the years, such as state constitutional limits on taxes (e.g.,

124. Hunter Atkins, *The $4,000 Titanium Toothbrush*, FORBES (Oct. 22, 2014, 11:46 AM), https://www.forbes.com/sites/hunteratkins/2014/10/22/the-4000-toothbrush [https://perma.cc/G38C-N8MY]; Nat Berman, *The Five Most Expensive Toilets in the World*, MONEY INC (June 24, 2018), https://moneyinc.com/the-five-most-expensive-toilets-in-the-world [https://perma.cc/YET8-2RHL].

Proposition 13) or supermajority voter approval requirements to raise taxes.[125] While Congress no doubt has the prerogative to make such changes, favoring non-tax transfers to homeless shelters over tax transfers to the same shelters, future Congresses may wish to treat all such transfers the same. The next Part considers those options.

IV. LEGISLATIVE OPTIONS FOR "SOCIAL CONTRIBUTIONS"

There are several legislative options available for Congress to eliminate the discontinuity in the law described in this Article. First, and most obviously, Congress could reinstate the deduction for state and local taxes, reversing the limitations introduced via TCJA in December 2017. This approach seems very unlikely, at least given the current political composition of the legislative branches of government. Among other things, simply repealing the SALT cap, unless accompanied by offsetting revenue-increasing changes in the law, would result in a significant decline of federal revenue. Alternatively, Congress could repeal the deduction for charitable contributions or impose a cap similar to the $10,000 SALT cap. Given the broad political support for this provision, this option also seems unlikely-though it too would restore neutrality as between state and local taxes and charitable contributions.

An alternative legislative option—that would have the desired effect of treating state and local taxes and charitable contributions the same—would be to combine the tax treatment of the two types of outlays into a single provision governing "social contributions." Congress could then subject the taxpayer's total social contributions for the year to a single uniform limitation, either applying a floor, a ceiling, or some combination of those common statutory devices.

For example, consider a limitation of the sort advocated for more general usage by Martin Feldstein and others.[126] The idea of a Feldstein cap is to allow itemized deductions but to limit the extent to which those deductions, in combination, would reduce the taxpayer's tax liability. For example, a rule might specify that the taxpayer's itemized deductions can reduce her aggregate tax liability by no more than

125. *See, e.g.*, CAL. CONST. art. XIIIA, § 2(a) (limiting property taxes and restricting annual increases to an inflation factor not to exceed two percent per year); FLA. CONST. art. VII, § 19 (requiring a supermajority to impose, authorize, or raise state taxes or fees).

126. Martin Feldstein et al., *Capping Individual Tax Expenditure Benefits* (Nat'l Bureau of Econ. Research, Working Paper No. 16,921), http://papers.nber.org/papers/w16921 [https://perma.cc/CPH2-SHDB].

some percentage of adjusted gross income, perhaps 5%. Thus, a taxpayer with $500,000 of adjusted gross income (AGI) would be allowed to claim capped deductions, but in combination, the deductions could reduce her tax liability by no more than $25,000. Assuming (for the sake of analysis) a marginal rate of 40%, this would mean that deductions up to $62,500 would be allowed. Intriguingly, while advocating for overall cap itemized deductions, Feldstein himself took the position that there should be a special carve-out for charitable contributions.[127] In Feldstein's view "[t]he full deduction for charitable contributions should be retained, because *the money that taxpayers give to charity benefits those organizations rather than the individual taxpayer.*"[128] One might reasonably take issue with this assertion, but to whatever extent Feldstein is correct in highlighting the benefits of charitable outlays to donee organizations, the same logic applies in the case of most state and local tax payments made by itemizing taxpayers. If a carve-out for redistributive outlays is appropriate, that carve-out should apply to all such payments, regardless of whether those payments take the form of charitable gifts or state/local taxes. But of course providing such a carve-out substantially dilutes the desired effect of the cap (to broaden the tax base and limit deductions). Thus, if some version of Feldstein's cap were to be used, the better approach would be to apply it uniformly to these similar types of outlays.

An alternative means of limiting deductions is to utilize a floor so that the total outlay is deductible only to the extent that it exceeds some specified threshold, perhaps based on a percentage of AGI, as is done with medical expenses.[129] As compared to statutory ceilings, floors have the advantage of preserving the incentive at the margin, so that any increase in the total amount of the outlay above the floor increases the amount of the tax benefit. Put differently, utilizing a floor enables policymakers to reduce the overall cost of the subsidy while preserving the intended incentive effects. There are numerous design

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127. Martin Feldstein, *It's Time to Cap Tax Deductions*, WASH. POST (Mar. 12, 2013), https://www.washingtonpost.com/opinions/its-time-to-cap-tax-deductions/2013/03/12/af05081c-8a63-11e2-8d72-dc76641cb8d4_story.html.

128. *Id* (emphasis added).

129. *Hearing on Tax Reform Options: Incentives for Charitable Giving Before the Comm. on Finance*, 112th Cong. 10 (2011) (statement of C. Eugene Steuerle, Richard B. Fisher Chair and Institute Fellow, Urban Institute); Deena Ackerman & Gerald Auten, *Floors, Ceilings, and Opening the Door for a Non-Itemizer Deduction*, 59 NAT'L TAX J. 509 (2006); Roger Colinvaux et al., *The Charitable Deduction: Policy and Analysis*, URBAN INST. 19 (2012).

possibilities for such an approach, as well as many examples from current and prior law. For our purposes, the essential feature is to subject all social contributions—whether they take the form of a tax payment of a charitable gift—to the same floor.

CONCLUSION: THE COGNATE NATURE OF TAXES AND GIFTS

A central question raised in this Article—and brought into focus by the new SALT cap, as well as the ongoing controversy regarding the federal tax treatment of state-level charitable tax credits—is how we should view taxes and charitable contributions. Are these two radically different things, warranting the differential tax treatment accorded by the new law? Or is tax-funded government spending simply another means of effectuating charitable investments? In his book, *Who Really Cares: The Surprising Truth about Compassionate Conservatism*, Arthur Brooks adopts an insistent tone on this point: "Let us be clear: *Government spending is not charity*. It is not a voluntary sacrifice by individuals. No matter how beneficial or humane it might be, no matter how necessary it is for providing public services, it is still the obligatory redistribution of tax revenues."[130]

If the post-TCJA debate over state charitable tax credits reveals nothing else, it is that rigid distinctions like this—between "voluntary sacrifice" of charitable giving on the one hand and "obligatory redistribution" of taxation on the other—simply do not hold up under scrutiny. Of course, it is always possible to posit extreme examples to score partisan points. Those who are ideologically committed to portraying "taxation" as coercive exactions bearing no resemblance to charitable giving might point to taxes we must all pay to fund legislators' salaries and compare those to voluntary gifts that some family makes to a local soup kitchen. Juxtaposing these extreme examples serves the political function of portraying taxes as feeding leviathan and gifts as high-minded acts of voluntary sacrifice. But it is just as easy to posit two alternative examples making the opposite point. Is a "gift" to the exclusive private school that one's children attend really all that charitable? How does that payment compare to the property taxes paid to support public schools in a poor neighborhood attended by underprivileged children? In many cases,

130. ARTHUR C. BROOKS, WHO REALLY CARES?: THE SURPRISING TRUTH ABOUT COMPASSIONATE CONSERVATISM, AMERICA'S CHARITY DIVIDE—WHO GIVES, WHO DOESN'T, AND WHY IT MATTERS 20 (2006).

perhaps even more often than not, government services funded by taxation will promote charitable purposes more effectively (and extensively) than private philanthropy ever can. The fact that individuals operationalize their charitable giving through the collective mechanism of taxation and government does not diminish its fundamentally charitable character.

If one were looking for a counterpoint to Brooks's paean to private philanthropy, a good candidate might be the statement, commonly attributed to Barney Frank, that "government is simply the name we give to the things we choose to do together."[131] But this perspective also seems incomplete, for surely there are many "things we choose to do together" that fall outside the ambit of "government"—most notably, those investments we make through the non-governmental charitable sector.[132] Whether the vehicle is Habitat for Humanity, the American Red Cross, or perhaps a local soup kitchen organized at one's church, synagogue, or mosque, the "things we do together" go well beyond the activities of government.

Ultimately, we need a conception of "charitable" transfers that is ecumenical enough to encompass the views expressed in both the Brooks and Frank statements. We may or may not want to use the federal tax system to promote charitable investments, but if we do, we should recognize that there are alternative methods of pooling resources and craft an approach that accommodates a diversity of approaches.

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131. Ross Douthat, *Government and Its Rivals*, N.Y. TIMES SR12 (Jan. 29, 2012).
132. *Id.*