

STATE AND LOCAL TAX CREDIT PROGRAMS – BUSINESSES MAY GET WHAT INDIVIDUALS CANNOT

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Since recent Federal tax law changes have capped the state and local tax deduction for individuals to \$10,000, many states have been trying to implement solutions to help alleviate the effects of the change. New York State has introduced two programs to get around the \$10,000 limitation: New Yorkers can make payments to state charitable programs and receive a credit against N.Y. income tax or, alternatively, use an Employer Compensation Expense Program.

In response to the states' efforts, the Treasury Department issued proposed regulations addressing the Federal income tax treatment of these programs as applicable to individuals. The proposed regulations state that if a taxpayer makes a payment or transfers property to or for the use of a charitable organization (including a state-operated charity) and the taxpayer receives or expects to receive a state or local tax credit in return for such payment, the tax credit constitutes a return benefit, or *quid pro quo*, to the taxpayer and reduces the taxpayer's charitable contribution deduction.

In response to the proposed regulations, the I.R.S. received questions regarding the application of the proposed regulations to business entities that make payments to charitable organizations pursuant to state and local tax credit programs. These questions related to the application of Code §162 to these payments. That is, whether a business entity may deduct these payments under Code §162 as ordinary and necessary business expenses incurred in carrying out a trade or business. Taxpayers worried that the *quid pro quo* theory of disallowance could apply equally to business deductions. After all, if the taxpayer received a benefit by the contribution, would that not be sufficient to disallow the deduction? On September 5, 2018, the I.R.S. released an F.A.Q. addressing these concerns. The I.R.S. stated that the discussion in the proposed regulations addressing the deductibility of such payments as charitable contributions for individuals does not affect the availability of a business expense deduction under Code §162.

Generally, a business taxpayer making a payment to a charitable or government entity described in Code §170(c) is permitted to deduct the entire payment as an ordinary and necessary business expense under Code §162 if the payment is made with a business purpose. The rules permitting an ordinary and necessary business expense deduction under Code §162 apply to a taxpayer engaged in carrying out a trade or business regardless of the form of the business.¹

Since the release of the F.A.Q., the Treasury Department and the I.R.S. continue to receive questions regarding the application of the proposed regulations and Code §§162 and 164 to taxpayers engaged in trades or businesses. These questions include whether payments by these taxpayers to charitable organizations in return for state income, property, and other business tax credits would bear a direct relationship to the taxpayer's trade or business, such that these payments would be

¹ ["State and Local Income Tax FAQ,"](#) I.R.S., last modified March, 22, 2019.

considered ordinary and necessary business expenses of carrying out such trade or business under Code §162(a) to the extent of the credit received or expected.

In further response, on December 28, 2018, the I.R.S. issued a Revenue Procedure² providing safe harbor rules for payments by C-corporation and pass-thru entities. Notably, the *quid pro quo* analysis does not appear to apply in this context.

To the extent a C-corporation receives or expects to receive a state or local tax credit in return for a payment to an organization described in Code §170(c), it is reasonable to conclude that there is a direct benefit to the C-corporation's business in the form of a reduction in the state or local taxes the C-corporation would otherwise have to pay. Therefore, to the extent of the amount of the credit received or expected to be received, there is a reasonable expectation of financial return to the C-corporation commensurate with the amount of the transfer.

A specified pass-thru can qualify for the similar deduction if it meets four tests:

- The entity is a business entity other than a C-corporation that is regarded for all Federal income tax purposes as separate from its owners.³
- The entity operates a trade or business within the meaning of Code §162.
- The entity is subject to a state or local tax incurred in carrying out its trade or business that is imposed directly on the entity.
- In return for a payment to a charitable organization the entity receives or expects to receive a state or local tax credit that the entity applies or expects to apply to offset a state or local tax.

The following two examples are offered:

- P is an L.L.C. classified as a partnership for Federal income tax purposes under Treas. Reg. §301.7701-3 and is owned by individuals A and B. P is engaged in a trade or business within the meaning of Code §162 and makes a payment of \$1,000 to a charitable organization. P receives or expects to receive a dollar-for-dollar state tax credit to be applied to P's state excise tax liability incurred by P in carrying out its trade or business. Under applicable state law, the state's excise tax is imposed at the entity level (not the owner level). P may treat the \$1,000 payment as meeting the requirements of an ordinary and necessary business expense under Code §162.
- S is an S-corporation engaged in a trade or business and is owned by individuals C and D. S makes a payment of \$1,000 to a charitable organization. In return for the payment, S receives or expects to receive a state tax credit equal to 80% of the amount of this payment (\$800) to be applied to S's local real property tax liability incurred by S in carrying out its trade or business. Under applicable state and local law, the real property tax is imposed at the entity level (not the owner level). S may treat \$800 of the payment as meeting the requirements of an ordinary and necessary business expense under Code §162. The treatment of the remaining \$200 will depend upon the facts and circumstances and is not affected by this revenue procedure.

² Rev. Proc. 2019-12, 2019-4 I.R.B. 401, December 28, 2018.

³ Treas. Reg. §301.7701-3.

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