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MEMORANDUM

TO: Cornerstone Schools

FROM: David H. Humber & Kyle M. Heslop

RE: Final Regulations Relating to Business Expense Deductions and State Tax Credits for Donations to Charitable Organizations

DATE: August 24, 2020

On August 11, 2020, the United States Department of the Treasury (the "Treasury") released final regulations (the "Final Regulations") providing a potential avenue for an individual taxpayer to receive state and local tax ("SALT") credits as a result of a pass-through businesses entity's donation to a charitable organization that qualifies as business expense.[1] The Final Regulations suggest that by characterizing charitable donations by certain C corporations and specified pass-through business entities (collectively, "PTEs") as business expenses, PTEs can claim a federal income tax deduction for the donation at an entity-level, while the individual owners of such entities could apply the SALT credits generated by the PTEs' donations to reduce their individual state tax liability, providing possible relief from the $10,000 SALT deduction cap.[2]

This memo provides a brief overview of the Final Regulations and related laws, rules and regulations. In particular, this memo analyzes the impact of the Final Regulations on donations by C corporations and PTEs to scholarship granting organizations ("SGOs") under Alabama law.

Background

Section 162(a) of the Internal Revenue Code (the "Code") provides a federal income tax deduction for all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. On the other hand, generally businesses and individuals deduct charitable contributions under Section 170 of the Code, because such deductions are generally not permitted to be classified as business expenses under Section 162 of the Code.[3] However, where all or a portion of a donation meets the Section 162 requirements described below, such qualifying amount can be deducted as a business expense instead of a charitable contribution.[4]

As mentioned above, contributions to charitable organizations are typically deductible by taxpayers under Section 170 of the Code, which allows a federal income tax deduction in the amount of such contribution, subject to certain limitations.[5] Section 170 deductions may only be taken by a taxpayer where the purpose of the contribution is purely charitable and in an amount that is limited by any consideration received by the taxpayer in exchange for the charitable gift.[6] Because of these limitations on Section 170 deductibility, where a taxpayer receives SALT credits from a state program in exchange for a donation to a charitable organization, the taxpayer may not take a Section 170 deduction for the amount of SALT credits received.[7]

Section 162 provides businesses a federal income tax deduction for certain donations of cash or cash equivalents made to charitable organizations[8] that qualify as reasonable business expenses.[9] Beneficially, Section 162 deductions do not share many of the same limitations as applied to deductions under Section 170 of the Code. To claim a Section 162 deduction for a charitable donation, (i) the donation must be a reasonable, ordinary and necessary expenditure made in carrying on a trade or business, (ii) the donation to the charitable organization must bear a "direct relationship to the taxpayer's trade or business" and (iii) the taxpayer must have "a reasonable expectation of financial return commensurate with the amount of the payment."[10]

In general, a deductible expenditure under Section 162 will be considered "ordinary and necessary," where the expenditure commonly occurs and is helpful in the development of the business being carried on.[11] Additionally, federal court decisions and federal agency guidance over the years have described various direct relationships that could qualify a charitable donation for a Section 162(a) deduction, including donations made for the purposes of advertising, name recognition and goodwill, improving neighborhoods and education systems to attract workers and customers, and improving employee health and morale.[12] The deductibility of any donation to a charitable organization under Section 162 of the Code will depend on the specific facts and circumstances relating to the donation, including the reasonableness of the amount of the donation and the business' reasonable expectation for a financial benefit.

The Alabama Accountability Act of 2013 (the "Accountability Act") provides individual and corporate taxpayers with a state income tax credit equal to the amount of any charitable contributions made to Alabama SGOs, subject to certain limitations.[13] In turn, SGOs administer educational scholarships to students currently attending failing schools to offset the costs of transferring the students to non-failing public or nonpublic schools. Under the Accountability Act, the state income tax credit generated by a PTE's donation to a charitable organization may be claimed by the individual owners of the PTE.[14]

The Final Regulations

The Final Regulations provide certain clarifications and safe harbors that depict a potential path to obtaining both a federal income tax deduction at an entity-level and individual tax credit for business owners where a donation from a PTE to a charitable organization generates a SALT credit pursuant to a state program. In doing so, the Final Regulations

theoretically allow PTEs to avoid the disallowance of Section 170 federal income tax deductions where a charitable donation produces SALT credits.[15] In the Final Regulations, the Treasury specifically acknowledges the negative impact on donations to SGOs from the IRS's denial of Section 170 deductions where SALT credits are generated.[16]

The Final Regulations reiterate that to generate a Section 162 business expense deduction, a donation from a PTE to a charitable organization must meet all of the Section 162 qualifications as a reasonable, ordinary and necessary business expense.[17] While the qualifying business purpose of the donation will need to be determined on a case-by-case basis, the Final Regulations clarify that, to the extent that a PTE makes a donation to a charitable organization with an expectation that it will receive a corresponding SALT credit in return, "it is reasonable to conclude that there is a direct benefit and a reasonable expectation of commensurate financial return to the . . . specified [PTEs'] business in the form of a reduction in" SALT liability.[18] Thus, the Final Regulations seem to state that in most cases where SALT credits are expected to be received by the business, that Section 162 requirement is met for a charitable donation. However, the more the donating PTE can establish that the requirements of Section 162 are satisfied by the donation to the charitable organization, the more likely it will be that deductibility of the donation will be upheld if challenged.

Furthermore, the Final Regulations clarify that, where a charitable donation could qualify for a Section 162 deduction for federal income tax purposes, such classification does not affect the availability for an individual taxpayer to apply the generated SALT credits to its state tax liability, including where the SALT credits are passed through the business to its individual owners.[19] The Treasury provided the below example of how these principles work under the Final Regulations:

> *Example 2*. P, a partnership, operates a chain of supermarkets, some of which are located in State N. P operates a promotional program in which it sets aside the proceeds from one percent of its sales each year, which it pays to one or more charities described in section 170(c). The funds are earmarked for use in projects that improve conditions in State N. P makes the final determination on which charities receive payments. P advertises the program. P reasonably believes the program will generate a significant degree of name recognition and goodwill in the communities where it operates and thereby increase its revenue. As part of the program, P makes a $1,000 payment to a charity described in section 170(c). P may treat the $1,000 payment as an expense of carrying on a trade or business under section 162. This result is unchanged if, under State N's tax credit program, P expects to receive a $1,000 income tax credit on account of P's payment, and under State N law, the credit can be passed through to P's partners.[20]

For instance, if a PTE were to make a qualifying donation to an Alabama SGO, and the SGO were to use the donation to fund scholarships for inner-city students in an area that the PTE has a significant presence in order to allow those students to transfer from under-performing public schools to a qualified private school, the PTE has a reasonable basis to classify its donation as a deductible business expense for federal income tax purposes (provided that the donation met all of the Section 162 requirements, including being reasonable, ordinary and necessary) while also passing through the Alabama tax credit received by the PTE under the Accountability Act to its individual owners.

Conclusion

The Final Regulations provide a business with a potential avenue for reducing its federal income tax liability, while at the same time benefiting its individual owners by allowing the pass through of corresponding SALT credits. However, the Final Regulations do not provide a one-size-fits-all roadmap for deductibility of a PTE's donation to a charitable organization under Section 162 or for the availability to pass through SALT credits to a PTEs' individual owners. Instead, the availability of a Section 162 deduction and SALT credit pass-through are subject to meeting each requirement of Section 162 and the safe harbors described in the Final Regulations, and therefore should be analyzed in each case for compliance with such requirements.

As this memo provides an overview of the Final Regulations and related laws, rules and regulations as of the date hereof, it is not intended to be a complete description of the laws, rules or regulations summarized herein. Therefore, this memo should not be relied on as legal or tax planning advice to any particular taxpayer without a full consideration of his, her or its specific facts and circumstances. Potential donors should consult their own tax advisors prior to making any donation that might be deductible under the laws, rules and regulations described in this memo.

Endnotes

[1] T.D. 9907 (Aug. 11, 2020).
[2] *Id.; see* I.R.C. § 164(b)(6). Pursuant to the Tax Cuts and Jobs Act, federal income tax deductions for SALTs paid by a taxpayer were capped at $10,000.
[3] *See* I.R.C. § 162(b).
[4] *See* I.R.C. § 162; T.D. 9907 at *8.
[5] I.R.C. § 170.
[6] *See id.*
[7] *See* Treas. Reg. § 1.170A-1(c)(5).
[8] Section 162 of the Code and the Final Regulations apply only to charitable organizations described in Section 170(c) of the Code, which includes, among other types of entities, corporations, trusts, funds or foundations "organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes."
[9] I.R.C. § 162(a).
[10] Treas. Reg. § 1.162-15(a).
[11] *See Welch v. Helvering*, 290 U.S. 111-113 (1993).
[12] *See, e.g.,* Treas. Reg. § 1.162-15(a) (examples 1 and 2); *United States v. Jefferson Mills, Inc.*, 367 F.2d 392 (5th Cir. 1966); *Marquis v. Comm'r*, 49 T.C. 695 (1968); *Boyd v. Comm'r*, T.C. Memo 2003-286; I.R.S. Rev. Rul. 63-73, 1963-1 C.B. 35; I.R.S. Rev. Rul. 72-134, 1972-1 C.B. 44; I.R.S. P.L.R. 9309006 (Mar. 5, 1993).
[13] *See* Ala. Code § 16-6D-9. The state income tax credit provided under Section 16-6D-9 is subject to certain limitations described therein, including, for individuals, that the credit not exceed 50% of the taxpayer's tax liability and is capped at $50,000 per tax year.
[14] *See* Ala. Code § 16-6D-9(a)(2).
[15] *Id.*; Treas. Reg. § 1.170A-1(h)(3); Rev. Proc. 2019-12, 2019-04 I.R.B. 401 (2018).
[16] T.D. 9907 at *11; ; Rev. Proc. 2019-12, 2019-04 I.R.B. 401 (2018).
[17] *See* Treas. Reg. § 1.162-15(a).
[18] T.D. 9907 at *8.
[19] *Id.* at *8-9.
[20] *Id.*