UNITED STATES CONFERENCE OF CATHOLIC BISHOPS

Office of the General Counsel

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January 31, 2020

Submitted Electronically

CC:PA:LPD:PR (REG-107431-19)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Notice of Proposed Rulemaking
REG-107431-19
Treatment of Payments to Charitable Entities in Return for Consideration

Dear Sir or Madam:

The United States Conference of Catholic Bishops ("USCCB") is pleased to offer this comment letter regarding the proposed Treasury regulations referenced above and issued on December 17, 2019. 84 Fed. Reg. 68,833.

Commendably, the proposed regulations would amend Treasury Regulations Section 1.162-15(a) to more clearly reflect the state of the law regarding a taxpayer's payment or transfer to a Section 170(c) entity. We support the proposal that a taxpayer's payment or transfer to a Section 170(c) entity bearing a direct relationship to its trade or business may constitute an allowable deduction as a Section 162 trade or business expense rather than a Section 170 charitable contribution regardless of whether the taxpayer expects to receive a state or local tax credit in return.

The USCCB is troubled, however, by the silence in the proposed regulations as to the rule set forth in the final regulations issued on Contributions in Exchange for State or Local Tax Credits barring individual taxpayers owing $10,000 or more in state and local credits from claiming a Section 170 charitable contribution deduction when the taxpayer receives state and local tax credits in return for their contribution. 84 Fed. Reg. 27,513 (June 13, 2019). We urge Treasury and the Internal Revenue Service ("IRS") to implement final regulations with an exception to the charitable contribution deduction limitations for gifts to charitable organizations that are not affiliated with a government entity, and that agree not to direct contributions received under state or local tax credit programs for any government activities.

History of Relevant Tax Law

Prior to the Tax Cuts and Jobs Act of 2017 (Pub. L. 115-97) (the "Act"), Section 164 of the Internal Revenue Code generally allowed an itemized deduction for the payment of certain taxes, including state and local real and personal property tax. Section 164(b)(6), which was added by the Act, limited an individual's deduction for the aggregate amount of state and local taxes paid during the calendar year to $10,000.

On August 27, 2018, Treasury issued proposed regulations that, among other things, disallowed or limited the federal charitable contribution deduction if the individual donor received or expected to receive, directly or indirectly, a state or local tax credit in return for the donation to an organization described in Section 170(c). 83 Fed. Reg. 43,563 (August 27, 2018). This rule became final in June 2019 when Treasury published final regulations incorporating this rule. 84 Fed. Reg. 27,513 (June 13, 2019). While the final regulations created an exception for taxpayers falling below the new $10,000 state and local tax credit cap, neither the final regulations nor the proposed regulations issued in December 2019 addressed an exception for taxpayers at or above the $10,000 state and local tax credit cap.

Background of the USCCB

The USCCB is a nonprofit corporation, the members of which are the active Catholic Bishops in the United States. USCCB advocates and promotes the pastoral teachings of the U.S. Catholic Bishops in such diverse areas of the nation's life as the free expression of ideas, fair employment and equal opportunity for the underprivileged, protection of the rights of parents and children, the sanctity of life, and the importance of education. Values of particular importance to the Conference are the protection of the First Amendment rights of religious organizations and their adherents, and the proper development of tax law jurisprudence, especially as to programs that benefit the poor and vulnerable.

Catholic Education in the United States

Catholic schools comprise the nation's largest private educator, with more than 6,300 schools educating over 1.8 million children in the United States today, many of whom come from low-income families, keeping with Catholic schools' long-standing tradition of providing disadvantaged children with a top-quality education. The USCCB is a voice for those schools and our Catholic community before the federal government.

According to statistics from the National Catholic Educational Association, 86.5% of graduates from Catholic high schools attend college, compared to just 44% from public schools.[1] Not only do Catholic schools motivate young people to succeed, but by providing a high-quality education at a lower cost per pupil, they save taxpayers approximately 21 billion dollars per year.[2]

However, much of this would not be possible without the parental choice afforded by scholarship tax credit programs. Approximately two dozen Catholic-led scholarship granting organizations ("SGOs") specifically work with state and local partners to distribute scholarships to children in need who seek better opportunities through Catholic education. These organizations rely on generous corporate and individual donors who are committed to serving children.

Scholarship Grant Programs

Many states have varying forms of scholarship tax credit programs that have been in existence since well before the enactment of the Tax Cuts and Jobs Act of 2017 (Pub. L. 115-97); Pennsylvania's program began in 2001, Iowa's program began in 2006, and Indiana's program began in 2009. States enacted these programs to encourage individual donors to make donations to such programs by providing the incentive of a state or local tax credit. Many children are unable to take advantage of the opportunities afforded through Catholic education without a scholarship to offset the cost. Higher donations to the scholarship tax credit programs translate to a greater number of students to which the scholarship granting organizations can distribute scholarships.

Scholarship tax credit programs have seen a significant decline in donations since Treasury initially proposed this approach in proposed Treasury regulations (83 Fed. Reg. 43,563 (August 27, 2018)) and have seen a further decline since Treasury issued final regulations on Contributions in Exchange for State or Local

[1] NAT'L CATHOLIC EDUC. ASS'N, ANNUAL STATISTICAL REPORT ON SCHOOLS, ENROLLMENT AND STAFFING: UNITED STATES CATHOLIC ELEMENTARY AND SECONDARY SCHOOLS 2017-18.
[2] *Id.*

Tax Credits barring individual taxpayers owing $10,000 or more in state and local credits from claiming a Section 170 charitable contribution deduction when the taxpayer receives state and local tax credits in return for his or her contribution. 84 Fed. Reg. 27,513 (June 13, 2019). Lower donations to the scholarship programs have resulted in fewer scholarships given to children in Catholic schools nationwide.

We present the following examples, which, though not exhaustive, illustrate the impact the decline in donations due to individual taxpayers who are no longer permitted to claim a Section 170 charitable contribution deduction when the taxpayer receives state and local tax credits in return for his or her contribution has had on several state's scholarship tax credit programs:

- The Iowa School Tuition Organization Tax Credit Program, which has been in existence since 2006, has served over 10,000 students per year since 2010. The program estimates that $2,670,195 in total donations were lost in 2019. This amounts to 1,668 students who will not receive scholarships in 2020. It was the first time since 2008 that the Iowa program failed to exhaust all tax credits. When donors were polled, the overwhelming response was that the decision not to donate was because of the 2018 rule preventing Section 170 charitable contribution deductions when a state or local tax credit was received in exchange for the contribution.

- South Carolina's Exceptional SC program has been in existence since 2015 and has served 8,000 students since its inception. During the 2018 tax year, this program lost 700 individual donors due to the 2018 rule. This translates to $7.8 million dollars and 1,695 students who lost their scholarships.

- Virginia estimates that many of its individual donors were over the Section 164(b)(6) SALT cap. Accordingly, Virginia saw a decrease in donations to its scholarship tax credit program, resulting in a decrease in scholarships distributed to children. In 2018, two Catholic schools in the Diocese of Richmond reported issuing scholarships for 127 and 150 students respectively. In 2019, these same schools reported issuing only 82 and 118 scholarships to students, which reflects the significant impact of the decrease in donations; in two schools alone, 77 children who previously received scholarships in 2018 did not receive a scholarship for 2019. Of these 77 children, 50 did not return to their school. In addition, the Diocese of Arlington Scholarship Foundation, which was enacted in 2013, lost approximately $100,000 as a result of the 2018 rule, which translates to 24 students losing their scholarships.

The IRS estimated that a mere 1% of donors to SGOs would be impacted, but our review of the data shows a very different story. Currently, 18 states provide tax credits for taxpayers who contribute money to private, religious, or public K-12 school scholarship funds, which range from 50% to 100% of the amount contributed.[3] These programs allow high-income taxpayers who claim both a large state tax credit and the federal tax deduction for charitable contributions to receive tax benefits; however, such taxpayers must now reduce their charitable contribution deduction by the amount of state tax credit received, which, as reflected in the data above, has resulted in a significant decrease in donations.

Appropriately Targeting Revenue Loss

The final regulations attempted to address perceived revenue loss stemming from programs several states instituted to circumvent the federal limitations on deducting state and local taxes by creating new tax credit programs that direct taxpayer contributions to entities used to fund governmental activities. The scope of the final regulations extends far beyond this revenue concern. The broad scope stems from the final regulations' cross reference to Section 170(c), which consists of five categories of contributions or gifts the uses of which constitute a charitable contribution.

To narrow the broad scope stemming from the reference to Section 170(c) organizations, the final regulations should include an exception for gifts to charitable organizations that are not affiliated with a government entity and that agree not to direct contributions received under state or local tax credit programs for any government activities. With this exception, the regulations would match the revenue loss concerns directly with state and local government gifts meant to benefit government activities. Other qualified donors and successful and long-standing gifting structures would remain unaffected. If this change is implemented in the recently proposed regulations, it will correct the overly broad reach of the final regulations that was not addressed in these proposed regulations.

It should be noted that most state scholarship tax credit programs were implemented well before the enactment of the Tax Cuts and Jobs Act of 2017 (Pub. L. 115-97). In the proposed regulations issued in August 2018 (83 Fed. Reg.

[3] Institute on Taxation and Economic Policy, "Does Your State Offer Tax Credits for Private K-12 School Voucher Donations," (June 10, 2019), *available at* https://itep.org/does-your-state-offer-tax-credits-for-private-k-12-school-voucher-donations/.

43,568), Treasury and the IRS expressed concern that following the enactment of Section 164(b)(6), state and local governments were incentivized to create new tax credit programs and direct taxpayer contributions to entities that could be used to fund governmental activities. The scholarship tax credit programs were not enacted in response to the enactment of Section 164(b)(6), but to benefit children. These programs existed without objection prior to the enactment of Section 164(b)(6) and are not the programs Treasury and the IRS are trying to prevent. Accordingly, the broad scope of the regulations should be narrowed to create an exception for gifts to narrowly defined eligible charitable organizations to appropriately address the concerns Treasury and the IRS expressed.

Tax Policy Rationales and Objectives

The final regulations instituted a new bright line approach to the judicial doctrine known as "quid pro quo." Under this longstanding judicial rule, a taxpayer's charitable contribution deduction is reduced to the extent the taxpayer receives valuable consideration in exchange for making the contribution. In other words, the taxpayer receives an economic motivation for the gift.

Although fundraising practices vary significantly among non-profits across the country, traditional return benefits have included admissions to charitable events, bazaars, banquets, shows and athletic events. For decades, the Internal Revenue Service used administrative guidelines and safe harbors to help advise donors about the benefits received in return for contributions. *See* Revenue Procedure 90-12, 1990-1 C.B. 971. This longstanding public ruling guidance supports full charitable deductions where the return benefits consist of small items that are difficult or burdensome to value. In effect, the return benefit is inconsequential or insubstantial.

Before the final regulations, the Internal Revenue Service considered state tax credits inconsequential or insubstantial. In this environment, Catholic organizations, as well as secular and other religious organizations, have developed and implemented a wide variety of gifting programs including scholarship grant programs that are supported by state tax credits. The success of the programs has been hard-earned and successfully employed state tax incentives.

In an about face, the Internal Revenue Service provided in the final regulations that the application of the quid pro quo principle to state and local tax credits received in exchange for Section 170 charitable contributions "provides a more sound, comprehensive, and administrable approach." 84 Fed. Reg. at 27,517 (June 13, 2019). The Internal Revenue Service further provided:

> The Treasury Department and the IRS have determined that the tax laws and sound tax policy support the treatment of a state tax credit as a return benefit that reduces the amount of the taxpayer's charitable contribution deduction under section 170, regardless of whether the entity to which the contribution is made is controlled by a state or local government.

84 Fed. Reg. at 27,517 (June 13, 2019).

Many secular and religious organizations developed scholarship grant programs supported by tax credits on the basis that the Internal Revenue Service would continue to treat a state tax credit as a return that does not reduce a taxpayer's charitable contribution deduction. Many states developed these scholarship grant programs well before the enactment of Section 164(b)(6), which limits an individual's deduction for the aggregate amount of state and local taxes paid during the calendar year. Scholarship grant programs supported by state tax credits were not instituted as an attempt to circumvent the state and local tax deduction cap and did not significantly contribute to the revenue loss that resulted following the enactment of many state programs directing taxpayer contributions to entities that could be used to fund government activities. Accordingly, these scholarship grant programs are not the programs Treasury and the IRS were targeting when they published the final regulations.

Conclusion

We appreciate the opportunity to present our serious concerns and ask that Treasury and the IRS include an exception in the final regulations on Treatment of Payments to Charitable Entities in Exchange for Consideration allowing taxpayers above the $10,000 SALT cap to claim a charitable contribution deduction even when state or local tax credits are received for gifts to charitable organizations that are not affiliated with a government entity and that agree not to direct contributions received under state or local tax credit programs for any government activities.

Respectfully submitted,

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