Office of Chief Counsel
Internal Revenue Service
memorandum

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subject: Transferable State Tax Credits

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayers =
State =
W =
X =
Y =
Z =
Year 1 =
Year 2 =
a =
b =
c =
d =
e =
f =
g =
h =

i =
j =
k =
l =
m =
n =
o =
p =

ISSUES

Is a payment of cash to either a state agency or a charitable organization considered a charitable contribution under § 170 of the Internal Revenue Code or a payment of state tax possibly deductible under § 164 if, instead of a state tax charitable deduction, the payment entitles the taxpayer to a transferable state tax charitable credit?

Is a transfer of property to either a state agency or a charitable organization considered a charitable contribution under § 170 or a disposition of property under § 1001 coupled with a possible deduction under § 164 if, instead of a state tax charitable deduction, the transfer entitles the taxpayer to a transferable state tax charitable credit?

CONCLUSIONS

In the instant case, the payment is considered a charitable contribution under § 170, not a payment of tax possibly deductible under § 164.

In the instant case, the transfer of property is considered a charitable contribution under § 170, not a disposition of the property in satisfaction of the state tax liability.

FACTS

State provides a number of programs that use tax credits as incentives. State statutes dictate the type and features of each tax credit program. A taxpayer that meets the statutory provisions of a particular tax credit program is eligible to receive State tax credits. Generally, the credits may be used to offset various State tax liabilities, including the individual state income tax. Taxpayers contributed to the following four state tax credit programs. In each case, the recipient was a government or charitable entity that is eligible to receive deductible charitable contributions under § 170(c).

1. Contributions of money or property to the W Fund qualify for a credit against State income tax (excluding certain withholding taxes) . The amount of the credit is *a*% of the amount contributed and may be carried forward for up to five years. A taxpayer may sell, assign, exchange, convey or otherwise transfer the credits for no less than *b*% of the par value of the credits, and in an amount not to exceed *c*% of annual earned credits.

2. Contributions to the X Program qualify for a credit against State income tax. The amount of the credit is up to *d*% of the amount contributed and may be carried forward for up to five years.

3. Contributions of money or property to the Y Program qualify for a credit against State income tax (excluding certain withholding taxes). The amount of the credit is equal to *e*% of property contributions and *f*% of monetary contributions, and may be carried forward for up to five years.

4. Contributions of cash, stock, bonds or other marketable securities, or real property to the Z Shelter qualify for a credit against State income tax. The amount of the credit is *g*% of the amount contributed and may be carried forward for up to four years.

Taxpayers filed a joint Year 1 federal income tax return and claimed a charitable contribution deduction of $*h*. The contributions consisted of $*i* of cash, and appreciated property (shares of publicly traded stock) worth $*j*.

Taxpayers submitted applications to the State Department of Economic Development for $*k* of the contributions. The applications were accepted and taxpayers were granted State tax credits equal to *a*% of the approved contributions. Taxpayers used $*l* of the State tax credits to offset their Year 1 State income tax liability; sold $*m* of the State tax credits to other individuals; and carried forward $*n* of the State tax credits.

Taxpayers filed a joint Year 2 federal income tax return and claimed a charitable contribution deduction of $*o*. The contributions consisted solely of cash. Taxpayers submitted applications to the State Department of Economic Development for $*p* of the contributions. The applications were accepted and taxpayers were granted State tax credits equal to *a*% of the approved contributions. Taxpayers used these State tax credits to offset their Year 2 State tax liability.[1]

LAW AND ANALYSIS

Section 170(a)(1) allows as a deduction any charitable contribution payment made within a taxable year.

Generally, to be deductible as a charitable contribution under § 170, a transfer to a charitable organization or government unit must be a gift. A gift for this purpose is a transfer of money or property without receipt of adequate consideration, made with charitable intent. A transfer is not made with charitable intent if the transferor expects a direct or indirect return benefit commensurate with the amount of the transfer. If a taxpayer receives a benefit in return for a transfer to a charitable organization, the

[1] The taxpayers also used the $*n* in State tax credits carried forward from Year 1 to offset their Year 2 State tax liability.

transfer may be deductible as a charitable contribution, but only to the extent the amount transferred exceeds the fair market value of the benefit received, and only if the excess amount was transferred with the intent of making a gift. See United States v. American Bar Endowment, 477 U.S. 105, 116-118 (1986); Hernandez v. Commissioner, 490 U.S. 680, 689-691 (1989); § 1.170A-1(h)(1) and (2) of the Income Tax Regulations.

If the benefits expected to be received by a donor are substantial (that is, greater than those incidental benefits that inure to the general public from transfers for charitable purposes), then the transferor has received a *quid pro quo* sufficient to remove the transfer from the realm of deductibility under § 170. Singer Co. v. United States, 449 F.2d 413, 422-423 (Ct. Cl. 1971).

The tax benefit of a federal or state charitable contribution deduction is not regarded as a return benefit that negates charitable intent, reducing or eliminating the deduction itself. See McLennan v. United States, 23 Cl. Ct. 99 (1991), subsequent proceedings, 24 Cl. Ct. 102, 106 n.8 (1991), aff'd, 994 F.2d 839 (Fed. Cir. 1993); Skripak v. Commissioner, 84 T.C. 285, 319 (1985); Allen v. Commissioner, 92 T.C. 1, 7 (1989), aff'd, 925 F.2d 348 (9th Cir. 1991). Similarly, when the contribution is in the form of property, the value of the deduction has not been treated as an item of income under § 61, in the form of an amount realized on the transfer under § 1001. See Browning v. Commissioner, 109 T.C. 303 (1997) (value of state and federal tax benefits not part of the amount realized from a bargain sale of donated property).

The issue raised by the current fact pattern is whether, in this respect, a tax benefit in the form of a state tax credit, or a transferable state tax credit, is distinguishable from the benefit of a state tax deduction.

This office has previously analyzed this issue in the context of similar charitable credits. Specifically, we have analyzed the donation of cash to a state agency, in exchange for state charitable tax credits, and we have analyzed the donation of property to a state agency or to a § 501(c)(3) organization, in exchange for refundable and transferable state charitable tax credits. In both instances we did not resolve the issue, but instead suggested that the issue could be addressed in official published guidance.

At this time, published guidance on the issue is not contemplated. Based on our analysis of existing authorities, we conclude that the position reflected in McLennan, Browning, and similar case law generally applies. There 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. Generally, however, a state or local tax benefit is treated for federal tax purposes as a reduction or potential reduction in tax liability. As such, it is reflected in a reduced deduction for the payment of state or local tax under § 164, not as consideration that might constitute a *quid pro quo*, for purposes of § 170, or an amount realized includible in income, for purposes of §§ 61 and 1001. See, e.g., Rev. Rul. 79-315, 1979-2 C.B. 27, Holding (3) (the amount of a state tax rebate credited against tax is neither included

in income nor allowable as a deduction under § 164); Snyder v. Commissioner, 894 F.2d 1337 (6th Cir. 1990) (unpublished opinion), 1990 WL 6953, 1990 U.S. App. LEXIS 1603 (state tax reductions granted to horse-racing track that makes capital improvements are not income but simply reduce deductible tax liabilities). In this respect, we see no reason under McLennan, Browning, and similar case law to distinguish between the value of a state tax deduction, and the value of a state tax credit, or to draw a bright-line distinction based on the amount of the tax benefit in question.

Similarly, the fact that the excess charitable credits in the instant case could be carried over -- or, in the case of contributions to the W Fund, transferred to other taxpayers -- does not, in our view, change the characterization of the credit from a reduction or potential reduction in liability to consideration received in return for the charitable contribution. If, as occurred in the instant case, a portion of the credit is sold to another taxpayer, the proceeds are an amount realized from the disposition of the credit, a zero-basis asset in the taxpayers' hands. The proceeds of selling the credit do not reduce the taxpayer's deduction under § 170 and, to the extent the contribution was of property, the proceeds of selling the credit cannot be treated as an amount realized from a disposition of the contributed property, a treatment that would be inconsistent with the premise that the property was donated, not sold.

Accordingly, in the instant case Taxpayers may take a § 170 deduction for the full amount of their charitable contributions of cash and appreciated stock, assuming the requirements of § 170 are otherwise met. Taxpayers are not entitled to a § 164 deduction for the amount of the state tax credit used to offset their State tax liability. The $*m* Taxpayers received in return for the transfer of excess State tax credits does not reduce Taxpayers § 170 deduction, but is instead includable in income as an amount realized from the sale of the credits.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call Justin G. Meeks at (202) 622-5020 if you have any further questions.