MEMO

TO: Empower Illinois Partners
FROM: Nathan C. Hoffman, Policy and Research Director
DATE: June 2019
SUBJECT: IRS Guidance and *Invest in Kids Act*

EMPOWER ILLINOIS

EXECUTIVE SUMMARY

Empower Illinois has reviewed the Internal Revenue Service (IRS) regulation regarding the federal deductibility of donations made to nonprofit entities, specifically where a state-level tax credit is also being claimed. The regulation affects state tax credit scholarship programs, and may impact the Illinois *Invest in Kids Act* in the future.

The IRS regulation clarifies that taxpayers contributing to tax credit scholarship programs may receive the full federal charitable deduction in addition to the State and Local Tax (SALT) deduction, so long as the combined deductions do not exceed 100 percent of the contribution. The IRS did provide some relief to states whose tax credit scholarship programs provide a dollar-for-dollar credit on donations, ensuring those taxpayers will have access to the full federal deduction on top of the deduction, up to the $10,000 cap. But the rule ensures that no donor will receive a net profit from their donation.

BACKGROUND

The 2017 (federal) Tax Reform and Jobs Act (TRJA) includes a $10,000 cap on the State and Local Tax deduction. This cap has increased federal taxes for many residents in states with higher tax rates, thus prompting states to develop workarounds. Left to their own devices, these workarounds would be costly to the federal Treasury (nearly $700 billion over a decade). The new IRS rule is designed to prevent these workarounds.

The IRS rule is also designed to ensure that donors do not make a profit for contributions to tax credit scholarship programs, which was a concern shared by Illinois lawmakers when they prohibited the federal deduction if a donor claimed any state and local tax credit under the *Invest in Kids Act*. The final IRS rule ensures that tax credit scholarship donors will not receive a state credit and/or federal deduction whose combined value exceeds 100 percent of the donation amount. The rule will be especially relevant in states where the state credit is either close to or reaches 100 percent.

THE RULE

The final IRS rule treats state tax credits and deductions differently.

- A taxpayer will generally not be required to reduce his/her federal charitable deduction on account of receiving a state or local deduction, but this applies only in situations where the taxpayer's deductions will not exceed 100 percent of the value of their donation. If the taxpayer expects to receive more than 100 percent of the value of the contribution when applying the federal deduction in addition to the state/local deduction, the taxpayer must reduce his/her federal deduction.
- Regarding state tax credits, a federal deduction may only be claimed for the out-of-pocket amount after the credit is claimed (i.e. the taxpayer may take a federal deduction of $40 after claiming a state credit of $60/60 percent for their $100 donation). The rule also provides an exception (not applicable to the *Invest in Kids Act*) for donations where the expected credit will be less than 15 percent of the contribution.
- Regardless of the scenario or state-level mechanism, the rule ensures that the underlying SALT cap of $10,000 remains in effect.

INVEST IN KIDS IMPACT

As noted above, the *Invest in Kids Act* specifically prohibits claiming a federal tax deduction for contributions made to the program, where the donor accepted the 75 percent state credit on any portion of the contribution. This was intended in the original legislation to protect against donors making a profit on their contribution. Absent a change in state law or guidance from the Illinois Department of Revenue to the contrary, Empower Illinois does not believe the federal rule changes this.

Should the *Invest in Kids Act* be amended to remove this prohibition, this IRS rule would mean that Illinois taxpayers could claim a deduction specifically for the portion of the donation (i.e. 25 percent) for which a state credit may not be claimed, thus ensuring more tax dollars remain in the State of Illinois and continuing to safeguard against donors making a profit on contributions.

Read the full IRS rules here.