SECTION 1. PURPOSE

This revenue procedure provides safe harbors under section 162 of the Internal Revenue Code (Code) for certain payments made by a C corporation or a specified passthrough entity to or for the use of an organization described in section 170(c) if the C corporation or specified passthrough entity receives or expects to receive a state or local tax credit in return for such payment.

SECTION 2. BACKGROUND

Section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 162(b) provides that no deduction shall be allowed under subsection (a) for any contribution or gift that would be allowed as a deduction under section 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payments set forth in that section.

Section 170(a)(1) generally allows an itemized deduction for any “charitable contribution” paid within the taxable year. Section 170(c) defines “charitable
contribution” as a “contribution or gift to or for the use of” any organization described in
that section. Under section 170(c)(1), such an organization includes a State, a
possession of the United States, or any political subdivision of the foregoing, including
the District of Columbia. Section 170(c)(2) includes certain corporations, trusts, or
community chests, funds, or foundations, organized and operated exclusively for
religious, charitable, scientific, literary, or educational purposes, or to foster national or
international amateur sports competition, or for the prevention of cruelty to children or
animals.

Section 1.170A-1(c)(5) provides that transfers of property to an organization
described in section 170(c) that bear a direct relationship to the taxpayer’s trade or
business and that are made with a reasonable expectation of financial return
commensurate with the amount of the transfer may constitute allowable deductions as
trade or business expenses rather than as charitable contributions.

Section 164(a) allows a deduction for the payment of certain taxes, including:
(1) state and local, and foreign, real property taxes; (2) state and local personal property
taxes; and (3) state and local, and foreign, income, war profits, and excess profits taxes.
In addition, section 164 permits a deduction for taxes not described in the preceding
sentence that are paid or accrued within the taxable year in carrying on a trade or
business or an activity described in section 212. Moreover, section 164(b)(5) provides
taxpayers an annual election to allow a deduction under section 164(a) for the payment
of state and local general sales taxes in lieu of state and local income taxes.

Section 164(b)(6), as added by section 11042(a) of “An Act to provide for
reconciliation pursuant to titles II and V of the concurrent resolution on the budget for
fiscal year 2018”, Pub. L. 115-97, provides that deductions for foreign real property taxes are not allowable under section 164(a)(1) and limits an individual’s deduction to $10,000 ($5,000 in the case of a married individual filing a separate return) for the aggregate amount of the following state and local taxes paid during the calendar year: (1) real property taxes; (2) personal property taxes; (3) income, war profits, and excess profits taxes; and (4) general sales taxes. This limitation applies to taxable years beginning after December 31, 2017, and does not apply to foreign taxes described in section 164(a)(3) or to any taxes described in section 164(a)(1) and (2) that are paid and incurred in carrying on a trade or business or an activity described in section 212.

Since the enactment of section 164(b)(6), some taxpayers have looked for ways to avoid the new limitation on the deductibility of their state and local taxes. In response to these efforts, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) have issued guidance on whether certain approaches correctly apply the Code and Treasury regulations. On June 11, 2018, the Treasury Department and the IRS issued Notice 2018-54, 2018-24 I.R.B. 750, announcing the intention to propose regulations addressing the federal income tax treatment of transfers to certain transferees pursuant to state and local tax credit programs. On August 27, 2018, proposed regulations under sections 170 and 642(c) were published in the Federal Register (83 FR 43563). The proposed regulations generally state that if a taxpayer makes a payment or transfers property to or for the use of an entity listed in section 170(c), 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 under section 170(a).

After the publication of the proposed regulations, the Treasury Department and the IRS received questions from taxpayers and other stakeholders regarding the application of the proposed regulations to business entities that make payments to charitable organizations described in section 170(c) pursuant to state and local tax credit programs. These questions related to the application of section 162 to these payments, that is, whether a business entity may deduct these payments under section 162 as ordinary and necessary business expenses incurred in carrying on a trade or business.

On September 5, 2018, the IRS released an FAQ addressing these concerns. The FAQ states that the proposed regulations do not affect the availability of an ordinary and necessary business expense deduction under section 162. Specifically, the FAQ states that a business taxpayer making a payment to a charitable or government entity described in section 170(c) is generally permitted to deduct the payment as an ordinary and necessary business expense under section 162 if the payment is made with a business purpose. The FAQ also notes that the rules permitting an ordinary and necessary business expense deduction under section 162 apply to a taxpayer engaged in carrying on a trade or business regardless of the form of the business.

Since the release of the FAQ, the Treasury Department and the IRS have continued to receive questions regarding the application of the proposed regulations and sections 162 and 164 to taxpayers engaged in trades or businesses. These questions include whether payments by these taxpayers to organizations described in
section 170 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 considered ordinary and necessary business expenses of carrying on such trade or business under section 162(a) to the extent of the credit received or expected.

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 section 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 and, 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.

Similarly, in the case of a business entity other than a C corporation that is regarded as separate from its owner for all federal tax purposes under section 301.7701-3 of the Procedure and Administration Regulations (passthrough entity) and that is operating a trade or business within the meaning of section 162, to the extent the credit received in return for such a payment can reduce the passthrough entity's tax liability, it is reasonable to conclude that there is a direct benefit to the passthrough entity in the form of a reduction in the state or local taxes the entity would otherwise have to pay. However, under the principles of sections 702 and 1366, the deductibility of the payment must be determined at the level of the individual owners of the entity if the credit received or expected to be received will reduce a state or local income tax subject to the limitations in section 164(b)(6).
Accordingly, section 3 of this revenue procedure provides a safe harbor for C corporations, and section 4 of this revenue procedure provides a separate safe harbor for specified passthrough entities described in section 4.02 this revenue procedure.

SECTION 3. SAFE HARBOR FOR C CORPORATIONS

.01 Scope. The safe harbor provided by this section 3 applies to a C corporation that makes payments described in section 3.02 of this revenue procedure in carrying on its trade or business.

.02 Safe harbor. If a C corporation makes a payment to or for the use of an organization described in section 170(c) and receives or expects to receive a tax credit that reduces a state or local tax imposed on the C corporation in return for such payment, the C corporation may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of section 162(a) to the extent of the credit received or expected to be received.

.03 Examples.

(1) Example 1. A, a C corporation engaged in a trade or business, makes a payment of $1,000 to an organization described in section 170(c). In return for the payment, A receives or expects to receive a dollar-for-dollar state tax credit to be applied to A’s state corporate income tax liability. Under section 3 of this revenue procedure, A may treat the $1,000 payment as meeting the requirements of an ordinary and necessary business expense under section 162.

(2) Example 2. B, a C corporation engaged in a trade or business, makes a payment of $1,000 to an organization described in section 170(c). In return for the
payment, B receives or expects to receive a tax credit equal to 80 percent of the amount of this payment ($800) to be applied to B’s local real property tax liability. Under section 3 of this revenue procedure, B may treat $800 as meeting the requirements of an ordinary and necessary business expense under section 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by this revenue procedure.

SECTION 4. SAFE HARBOR FOR SPECIFIED PASSTHROUGH ENTITIES

.01 Scope. The safe harbor provided by this section 4 applies to a specified passthrough entity described in section 4.02 of this revenue procedure that makes payments described in section 4.03 of this revenue procedure in carrying on its trade or business.

.02 Specified passthrough entity. An entity will be considered a specified passthrough entity described in this section 4.02 only if each of the requirements set forth in section 4.02(1) through (4) is satisfied.

(1) 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 under section 301.7701-3;

(2) The entity operates a trade or business within the meaning of section 162;

(3) The entity is subject to a state or local tax incurred in carrying on its trade or business that is imposed directly on the entity; and

(4) In return for a payment to an organization described in section 170(c), 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 described in section 4.02(3) of this revenue procedure other than a state or local income tax.
.03 Safe harbor. If a specified passthrough entity described in section 4.02 of this revenue procedure makes a payment to or for the use of an organization described in section 170(c) and receives or expects to receive a tax credit described in section 4.02(4) of this revenue procedure that the entity applies or expects to apply to offset a state or local tax described in section 4.02(3) of this revenue procedure other than a state or local income tax, the specified passthrough entity may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of section 162(a) to the extent of the credit received or expected to be received.

.04 Examples.

(1) Example 1. P is a limited liability company (LLC) classified as a partnership for federal income tax purposes under section 301.7701-3 and is owned by individuals A and B. P is engaged in a trade or business within the meaning of section 162 and makes a payment of $1,000 to an organization described in section 170(c). In return for the payment, 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 on its trade or business. Under applicable state law, the state’s excise tax is imposed at the entity level (not the owner level). Under section 4 of this revenue procedure, P may treat the $1,000 payment as meeting the requirements of an ordinary and necessary business expense under section 162.

(2) Example 2. 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 an organization described in section 170(c). In return for the payment, S receives or expects to receive a state tax credit equal to 80 percent of the amount of this payment ($800) to be applied
to S’s local real property tax liability incurred by S in carrying on its trade or business. Under applicable state and local law, the real property tax is imposed at the entity level (not the owner level). Under section 4 of this revenue procedure, S may treat $800 of the payment as meeting the requirements of an ordinary and necessary business expense under section 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by this revenue procedure.

SECTION 5. APPLICABILITY OF SAFE HARBORS

.01 Applicability date. This revenue procedure applies to amounts described in section 3.02 of this revenue procedure that are paid on or after January 1, 2018, by a C corporation described in section 3.01 of this revenue procedure. In addition, this revenue procedure applies to amounts described in section 4.03 of this revenue procedure that are paid on or after January 1, 2018, by a specified passthrough entity described in section 4.02 of this revenue procedure.

.02 No multiple deductions. Nothing in this revenue procedure may be construed as permitting a C corporation that applies the safe harbor in section 3.02 of this revenue procedure or a specified passthrough entity that applies the safe harbor in section 4.03 of this revenue procedure to treat the amount of any payment as deductible under more than one provision of the Code or Treasury regulations.

SECTION 6. DRAFTING INFORMATION

The principal authors of this revenue procedure are personnel from the Office of the Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the Treasury Department and the IRS participated in its development. For further
information regarding this revenue procedure, contact Robin Tuczak (202) 317-4059 (not a toll-free call).