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Comments Due by: **February 9, 2021**

SC REVENUE RULING #21-xx [DRAFT - 1/19/2021]

SUBJECT: Impact of Treasury Regulations on Charitable Contribution Deduction and State Tax Credits
(Income Tax)

EFFECTIVE DATE: Effective for all periods open under statute, except to the extent the Department follows federal regulations, those regulations are effective as of the date each regulation is effective for federal income tax purposes.

REFERENCES: S.C. Code Ann. Section 12-6-3790 (Supp. 2019)
Internal Revenue Code Section 162
Internal Revenue Code Section 164
Internal Revenue Code Section 170
Treasury Regulation 1.162-15(a)
Treasury Regulation 1.164-3(j)
Treasury Regulation 1.170A-1(h)(3)

SUPERSEDES: SC Information Letter #19-10

AUTHORITY: S.C. Code Ann. Section 12-4-320 (2014)
S.C. Code Ann. Section 1-23-10(4) (2005)
SC Revenue Procedure #09-3

SCOPE: The purpose of a Revenue Ruling is to provide guidance to the public. It is an advisory opinion issued to apply principles of tax law to a set of facts or general category of taxpayers. It is the Department's position until superseded or modified by a change in statute, regulation, court decision, or another Department advisory opinion.

PURPOSE

In April 2019, the Department issued SC Information Letter #19-10 informing taxpayers of the issuance of proposed Treasury Regulation 1.170A-1(h)(3)¹ which may impact a taxpayer's charitable contribution deduction amount if the taxpayer receives, or expects to receive, a corresponding South Carolina tax credit.

¹Proposed Treasury Regulation 1.170A-1(h)(3) was published by the IRS on August 27, 2018.

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On August 11, 2020, Treasury Regulation 1.170A-1(h)(3) became final and generally adopted the rules contained in the proposed regulation with only clarifying and technical changes. The IRS also issued Treasury Regulations 1.162-15(a) and 1.164-3(j) that explain when a payment that would otherwise qualify as a charitable contribution can be treated as an ordinary and necessary business expense under Internal Revenue Code (“IRC”) Section 162 or a payment of state and local taxes under IRC Section 164.²

South Carolina adopts IRC Sections 170, 162, and 164 and will apply the Treasury regulations promulgated under IRC Sections 170, 162, and 164 in calculating South Carolina taxable income. The regulations impact a taxpayer’s tax treatment of contributions made to a charitable organization for both federal and South Carolina income tax purposes when the taxpayer receives or expects to receive a state tax credit in exchange for the contribution.

These regulations and their impact on South Carolina taxpayers are discussed below. Examples are provided to illustrate the impact for a corporate and an individual South Carolina taxpayer receiving a state income tax credit.

FEDERAL TREASURY REGULATIONS - OVERVIEW³

A. Charitable Contribution Deduction Reduced when Taxpayer Receives a State or Local Tax Credit

Internal Revenue Code Section 170(a) generally allows a federal income tax deduction for charitable contributions made to an organization described in Code Section 170(c) (charitable organization).⁴ Treasury Regulation 1.170A-1(h)(3), however, provides that if a taxpayer makes a payment or transfers property to a charitable organization and receives a state or local tax credit for that contribution, the amount of the taxpayer’s charitable contribution deduction for federal income tax purposes is reduced by the amount of the tax credit received.

Exception: The regulation provides that the charitable contribution is not reduced if the amount of the state or local tax credit does not exceed 15% of the taxpayer’s payment or 15% of the fair market value of the property transferred by the taxpayer. If, rather than a credit, the taxpayer receives a state or local tax deduction that does not exceed the amount of payment or the fair market value of the property transferred, the taxpayer is not required to reduce its federal charitable deduction because of the state or local tax deduction.

Example: Individual A makes a \$1,000 payment to a charitable organization. In exchange for the payment, A receives a state tax credit equal to 70% of the amount paid to the charitable

²The effective date of these final regulations is August 11, 2020; however, the dates of applicability are earlier than the effective date of the final regulations and are located in Treasury Regulations 1.162-15(a)(4), 1.164-3(j)(7), and 1.170A-1(h)(3)(x) and (h)(4)(iii). Final Treasury Regulation 1.170A-1(h)(3) applies to amounts paid or property transferred by the taxpayer after August 27, 2018.

³This is a brief overview of the Treasury regulations. Questions regarding the federal income tax consequences of these regulations should be directed to the Internal Revenue Service or your tax advisor.

⁴Qualifying organizations under IRC Section 170(c) include states and their political subdivisions.

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organization. A's charitable contribution deduction for federal purposes is reduced by \$700 (\$1,000 contribution x 70% tax credit). Accordingly, A's federal charitable contribution deduction for the \$1,000 payment is \$300.

B. Treatment of Contribution as a Business Expense Deductible under IRC Section 162

Under Treasury Regulation 1.162-15(a)(1) and (2), a taxpayer that operates a trade or business can deduct a payment or transfer made to a charitable organization as a business expense under Code Section 162, rather than a charitable deduction under Code Section 170, if the payment or transfer: (1) bears a direct relationship to taxpayer's trade or business and (2) is made with a reasonable expectation of financial return (other than the state or local tax credit itself) commensurate with the amount of the payment or transfer.

Exception for Payments in Cash or Cash Equivalents. Notwithstanding the above, the regulation provides a safe harbor exception for C corporations. Under the safe harbor, a C corporation that makes a payment of cash or a cash equivalent to or for the use of a charitable organization and in return receives a state or local tax credit that reduces a tax imposed on it may deduct an amount equal to the credit received, or expected to be received, as a business expense. Treasury Regulation 1.162-15(a)(3)(i), (iii) and (iv).

The regulation also provides a safe harbor for pass through entities if the credit received, or to be received, will not reduce a state or local income tax and the entity: (1) is regarded as an entity separate from its owners and (2) is subject to a state or local tax incurred in carrying on its trade or business that is imposed directly on the entity. Treasury Regulation 1.162-15(a)(3)(ii), (iii) and (iv).

C. Treatment of Disallowed Contribution as a Payment of State and Local Taxes Deductible under IRC Section 164

Internal Revenue Code Section 164 provides a deduction for state and local taxes for individuals who itemize deductions. Under Treasury Regulation 1.164-3(j), an individual who itemizes deductions may treat the portion of a charitable contribution disallowed under Treasury Regulation 1.170A-1(h)(3) and made in cash or a cash equivalent as a payment of state or local tax under IRC Section 164, subject to the \$10,000 state and local tax limit under IRC Section 164(b)(6).

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IMPACT ON SOUTH CAROLINA TAXPAYERS

Treasury Regulation 1.170A-1(h)(3) affects the charitable contribution deduction amount claimed on a taxpayer's South Carolina income tax return if the taxpayer receives or expects to receive a state or local tax credit in exchange for the contribution.

Because South Carolina adopts IRC Section 170 and currently follows the Treasury regulations thereunder for determining a taxpayer's South Carolina taxable income, any reduction in a taxpayer's federal charitable contribution deduction required under Treasury Regulation 1.170A-1(h)(3) will also reduce the taxpayer's South Carolina charitable contribution deduction.

South Carolina tax credits affected by the Treasury regulations include:

- Conservation Credit - Code Section 12-6-3515⁵
- Community Development Credit - Code Section 12-6-3530⁶
- Industry Partnership Fund Credit - Code Section 12-6-3585⁷
- Exceptional Needs Children's Fund Credit - Code Section 12-6-3790(H)(1)⁸

In addition to the reduction of a charitable contribution deduction when a taxpayer receives a South Carolina tax credit, effects of the federal regulations may include:

- The treatment of a contribution as a business expense deduction.
- The treatment of the disallowed portion of contribution as an itemized deduction for state and local taxes.
- Requiring the taxpayer to add back the "deduction" for purposes of South Carolina income taxes.

This requirement may apply whether the deduction is a charitable contribution deduction, a business expense deduction, or an itemized deduction for state and local taxes. Code Section 12-6-3790(D)(2)(c) (Exceptional Needs Children's Fund credit) and Code Section 12-6-

⁵Subject to the caps and conditions in Code Section 12-6-3515, a taxpayer that qualifies for and claims a charitable deduction for a gift of land for conservation or for a qualified conservation contribution may claim a credit equal to 25% of the total amount of the deduction attributable to the gift of land or the qualified real property interest located in this State.

⁶This credit is no longer available unless more funds are authorized by the General Assembly.

⁷For South Carolina income tax purposes, a taxpayer cannot deduct the contributions that give rise to the Industry Partnership Fund credit pursuant to Code Section 12-6-3585(I).

⁸The refundable credit under Code Section 12-6-3790(H)(2) for tuition payments to eligible schools for an exceptional needs child in the taxpayer's custody or care is not a charitable contribution; it is not impacted by this advisory opinion.

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3585(I) (Industry Partnership Fund credit) both require this addback on the South Carolina income tax return. See Examples 1 and 2 below.

In addition, the South Carolina deduction for taxes permitted by IRC Section 164 is computed in the same manner as provided in IRC Section 164 except no deduction is allowed for state and local income taxes.⁹ Therefore, regardless of the credit statute, an individual who deducts a disallowed charitable contribution as a state and local income tax may have to add back some or all of the “deduction” for purposes of South Carolina income taxes.¹⁰

EXAMPLES – Illustrating the impact of the treasury regulations on the Exceptional Needs Children’s Fund credit

Note: Each particular credit and each taxpayer’s specific tax situation could result in a different answer.

The simplified examples illustrate the South Carolina tax consequences of the regulations for a corporate taxpayer and an individual taxpayer claiming the Exceptional Needs Children’s Fund credit in Code Section 12-6-3790(H)(1).

The exceptional needs children’s fund credit illustrated is equal to 100% of the taxpayer’s qualified contribution. The amount of the credit that can be claimed is limited to 60% of the taxpayer’s tax liability. If a taxpayer deducts the amount of the contribution on his federal return and claims this credit, the taxpayer must add back the amount of the deduction for purposes of South Carolina income taxes pursuant to Code Section 12-6-3790(D)(2)(c).

The examples assume:

- (a) The taxpayer meets the South Carolina income tax credit requirements; and
- (b) The Exceptional Needs Children’s Fund qualifies as an organization described in IRC Section 170(c).

⁹Code Section 12-6-1130(2).

¹⁰See SC Revenue Ruling #19-11 for additional guidance on the state tax deduction for individuals who itemize deductions.

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Example 1 – Corporation Contributes Cash to the SC Exceptional Needs Children’s Fund

Facts: In January 2021, Corporation C donates \$40,000 in cash to the SC Exceptional Needs Children’s Fund and receives a \$40,000 credit. Under Treasury Regulation 1.170A-1(h)(3), C’s federal charitable deduction is reduced by the SC credit received. C has determined for federal income tax purposes that it meets the requirements in Treasury Regulation 1.162-15(a) to treat the disallowed contribution amount as a business expense (and not as a charitable contribution). Corporation C has sufficient tax liability to use the entire credit in 2021.

| Exceptional Needs Children’s Fund Credit Code Section 12-6-3790(H)(1) | Corporate Donor |
|---|---|
| Charitable Contribution and SC Credit | |
| Contribution Payment for SC Credit | \$40,000 |
| SC Income Tax Credit - 100% of contribution | \$40,000 (\$40,000 contribution x 100%) |
| | |
| Federal Impact | |
| Federal Charitable Contribution Deduction Allowed under Regulation 1.170A-1(h)(3) | \$0 (\$40,000 contribution less \$40,000 SC credit) |
| Federal Business Expense Deduction Allowed under Regulation 1.162-15(a) | \$40,000 |
| | |
| SC Impact | |
| SC Credit | \$40,000 |
| SC Charitable Contribution Deduction | \$0 (same as federal) No SC adjustment is required |
| SC Income Tax Addition Adjustment – Addback of the federal business expense deduction allowed for the contribution under IRC Section 162 See Note below | \$40,000 addition to SC taxable income on Form SC 1120 |

Note: In this example, for South Carolina income tax purposes, Corporation C is allowed the SC credit, but is not allowed a deduction for its contribution. Code Section 12-6-3790(D)(2)(c) requires a taxpayer to add back any federal deduction claimed as a result of the payment that generated this credit. The addback results in the disallowance of the entire \$40,000 federal business expense deduction for South Carolina income tax purposes.

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Example 2 – Individual Contributes Cash to the SC Exceptional Needs Children’s Fund

Facts: In January 2021, Individual D donates \$8,000 in cash to the SC Exceptional Needs Children’s Fund and receives an \$8,000 credit. Under Treasury Regulation 1.170A-1(h)(3), D’s federal charitable deduction is reduced by the SC credit received. D itemizes his deductions. D paid \$3,000 of South Carolina income taxes during the year and \$1,000 in property taxes (before consideration of any disallowed charitable deduction). Individual D files a joint tax return and has sufficient tax liability to use the entire credit in 2021.

| Exceptional Needs Children’s Fund Credit Code Section 12-6-3790(H)(1) | Individual Donor |
|---|---|
| Charitable Contribution and SC Credit | |
| Contribution Payment for SC Credit | \$8,000 |
| SC Income Tax Credit - 100% of contribution | \$8,000 (\$8,000 contribution x 100%) |
| | |
| Federal Impact | |
| Federal Charitable Contribution Deduction Allowed under Regulation 1.170A-1(h)(3) | \$0 (\$8,000 contribution less \$8,000 SC tax credit) |
| Federal Itemized Deduction for State and Local Taxes under IRC Section 164 | \$10,000 (\$3,000 SC income taxes and \$1,000 SC property taxes paid plus \$6,000 of the \$8,000 SC tax credit disallowed as a charitable contribution claimed as itemized deduction) |
| Note: Currently, the state and local tax deduction cannot exceed \$10,000 ¹¹ | |
| | |
| SC Impact | |
| SC Credit | \$8,000 |
| SC Charitable Contribution Deduction | \$0 (same as federal) No SC adjustment is required |
| SC Income Tax Addition Adjustment - due to charitable contribution treated as an itemized deduction under IRC Section 164 and SC Code Section 12-6-1130(2) See Note below | \$9,000 addition to SC taxable income on Form SC 1040 (\$10,000 state and local cap less \$1,000 property taxes) |

Note: In this example, for South Carolina income tax purposes, Individual D is allowed the SC credit, but is not allowed a deduction for his contribution. Also, SC Code Section 12-6-1130(2) provides, in part, that the deduction for taxes permitted by IRC Section 164 is computed in the same manner as provided in IRC Section 164 except there is no deduction for state and local income taxes. Therefore, Individual D in this example must add back the \$6,000 of state taxes that he deducted on his federal individual income tax return for the disallowed charitable contribution, and the \$3,000 of state income taxes he paid and deducted on his federal income tax return.

¹¹The federal Tax Cuts and Jobs Act of 2017 amended IRC Section 164 for tax years beginning January 1, 2018 through December 31, 2025 by adding IRC Section 164(b)(6) to limit the individual federal itemized tax deduction to a combined, total deduction of \$10,000 (\$5,000 if “married filing separate”).