SCHOLARSHIPS *for* KIDS

# DONATIONS

## BUSINESS EXPENSE DEDUCTION AND STATE TAX CREDIT?

Recently released Federal Tax Regulations provide a potential dual benefit for individual owners of specified pass-through business entities ("PTEs") who donate to scholarship granting organizations ("SGOs").

Under the Final Regulations, a payment made by C corporations and PTEs to a charitable organization may qualify as an ordinary and necessary business expense deduction. By characterizing a charitable donation to an SGO as a business expense, C corporations and PTEs reduce their taxable income at the entity-level, and the individual owners of PTEs receive state and local tax ("SALT") credits. The SALT credit generated by the business's donation can be applied to the individual's state tax liability, providing possible relief from the federal cap of $10,000 on the SALT deduction.

## WHEN DOES A CHARITABLE DONATION QUALIFY AS A BUSINESS EXPENSE?

If the payment is a reasonable, ordinary and necessary expenditure incurred in carrying on the trade or business, and the entity "reasonably believes the program will generate a significant degree of name recognition and goodwill in the communities where it operates and thereby increase its revenue," then the donation may qualify as a business expense.

The Regulations provide an example stating a business may be entitled to a business expense deduction for payments made "for use in projects that improve conditions in the state." Therefore, a donation to an SGO may be deductible as a business expense since the payment assist in providing greater educational opportunities, and greater educational opportunities improve educational outcomes. Improved educational outcomes in the state allow for fiscal and economic savings, and attract business to the state.

Tax benefit of contributing $8,000 to Scholarships for Kids for Alabama income tax credit if contribution payment qualifies as business expense of pass-through entity owned by donor:

### 2020 FEDERAL INCOME TAX

| | NO CREDIT | WITH CREDIT |
|---|---|---|
| WAGES | 90,000 | 90,000 |
| SCHEDULE E - S CORP | 327,000 | 319,000 (1) |
| ADJUSTED GROSS INCOME | 417,000 | 409,000 |
| 20% QBI DEDUCTION | (65,400) | (63,800) |
| STATE INCOME TAXES PAID | (6,000) | (6,000) |
| REAL ESTATE TAXES | (3,000) | (3,000) |
| MORTGAGE INTEREST | (14,500) | (14,500) |
| CHARITABLE CONTRIBUTIONS | (2,500) | (2,500) |
| ITEMIZED DEDUCTIONS | (26,000) | (26,000) |
| PERSONAL EXEMPTIONS | - | - |
| TAXABLE INCOME | 325,600 | 319,200 |
| INCOME TAX | **66,303** | **64,767** |
| TAX CREDIT - DONTATION TO SFK | - | - |
| INCOME TAX WITHHELD | 8,000 | 8,000 |
| ESTIMATED PAYMENTS | 10,000 | 10,000 |
| INCOME TAXES PAID 2020 | 18,000 | 18,000 |
| TAXES OWED (REFUNDED) 2021 | 48,303 | 46,767 |

### 2020 ALABAMA INCOME TAX

| | NO CREDIT | WITH CREDIT |
|---|---|---|
| WAGES | 90,000 | 90,000 |
| SCHEDULE E - S CORP | 327,000 | 327,000 (2) |
| ADJUSTED GROSS INCOME | 417,000 | 417,000 |
| FEDERAL TAX DEDUCTION | (66,303) | (64,767) |
| FICA/MEDICARE TAX DEDUCTION | (6,885) | (6,885) |
| REAL ESTATE TAXES | (3,000) | (3,000) |
| MORTGAGE INTEREST | (14,500) | (14,500) |
| CHARITABLE CONTRIBUTIONS | (2,500) | (2,500) |
| ITEMIZED DEDUCTIONS | (26,885) | (26,885) |
| PERSONAL EXEMPTIONS | (3,000) | (3,000) |
| TAXABLE INCOME | 320,812 | 322,348 |
| INCOME TAX | **15,961** | **16,037** |
| TAX CREDIT - DONTATION TO SFK | - | 8,000 |
| INCOME TAX WITHHELD | 4,000 | 4,000 |
| ESTIMATED PAYMENTS | - | - |
| INCOME TAXES PAID 2020 | 4,000 | 12,000 |
| TAXES OWED (REFUNDED) 2021 | 11,961 | 4,037 |

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CPAs & ADVISORS

**WITHOUT DONATION:** Federal Taxes: $66,303 / State Taxes: $15,961 = Total Expenses Paid: $82,264

**WITH DONATION:** Federal Taxes: $64,767 / State Taxes: $8,037 (3) / Scholarships for Kids Donation: $8,000 = Total Expenses Paid: $80,804

Conclusion: **$1,459 Total Savings**

1) Reduced by donation of $8,000 to Scholarships for Kids as an ordinary business expense 2) Assuming the $8,000 donation deducted as a business expense by the S Corp for federal tax purposes must be added back for state income tax purposes in order to receive the tax credit against the Alabama income tax liability 3) State income tax liability of $16,037 less $8,000 credit for donation received

The projections above are for illustrative purposes only, not intended as tax advice applicable to an actual situation. Please consult your tax advisor.

Making a donation to a Scholarship Granting Organization through a pass-through entity, then claiming an individual tax credit against individual Alabama State income taxes, requires just a few simple steps, as follows.

Overview:

**Step 1:**
Register your entity with the online portal of The Alabama Department of Revenue (the Department), called My Alabama Taxes (MAT).

**Step 2:**
Designate online at MAT the Scholarship Granting Organization (SGO) to which your entity will donate, then follow a short series of instructions/steps online at MAT to record the donation and reserve a portion of the Remaining Alabama Scholarship Reserve.

**Step 3:**
Cause your entity to make its donation to the SGO.
*Note*: Checks must be written on the entity account.

**Step 4:**
The Department will review your donation and, upon approval, send written notice of approval.

**Step 5:**
The individual owners of the entity will claim the credit on their individual tax returns, pro rata to their ownership. Note: The Alabama Accountability Act limits individual taxpayers claiming credits to $50,000 per year. (https://revenue.alabama.gov/legal/alabama-accountabilityact/)

Step 6:
The pass-through entity will document in writing an acceptable rationale for making the donation to the SGO.

Details of Individual steps on Page 2.

**Setting up a MAT Account (Step 1)**:
Reserving a tax credit requires the use of the Alabama Department of Revenue's online portal, My Alabama Taxes (MAT). Taxpayers which have not previously set up an account with MAT will need to do so.

To set up an account with MAT, call the Alabama Department of Revenue ((334) 242-1200 or (334) 242-1033) or go online at MyAlabamaTaxes: https://myalabamataxes.alabama.gov/

If you set up an account by phone, you will need:
- Federal ID Number (EIN)
- Name of company
- Caller's position with company
- Account type (Pass-through entity)

Note – If your pass-through entity is already registered (e.g., already has a Business Privilege Tax Account), the Alabama Accountability Act option can simply be added to its existing registration.

**To Reserve Tax Credits (Step 2)**:
After registering the entity, go to the MAT website:
- Select "Pass-Through Entity" option.
- Select "I want to" option.
- Select "Report a donation to an SGO".
- Select your way through the following options:
  1. Select your Scholarship for Kids as the SGO
  2. Identify your donation amount
  3. Select your donation date
  4. Identify your deductible donation claim year
- Once you have completed the process, you will be given a confirmation number

**Making the Donation (Step 3):**
- Checks must be written on the entity account and received within 30 days of the donation registration.
- Checks should be sent to:
  Scholarship for Kids, Inc.
  PO Box 10204
  Birmingham, AL 35202
- Please include a note with the check expressing your support of Cornerstone Schools.
- Once the check is received, Scholarship for Kids will verify the donation with the Department of Revenue.

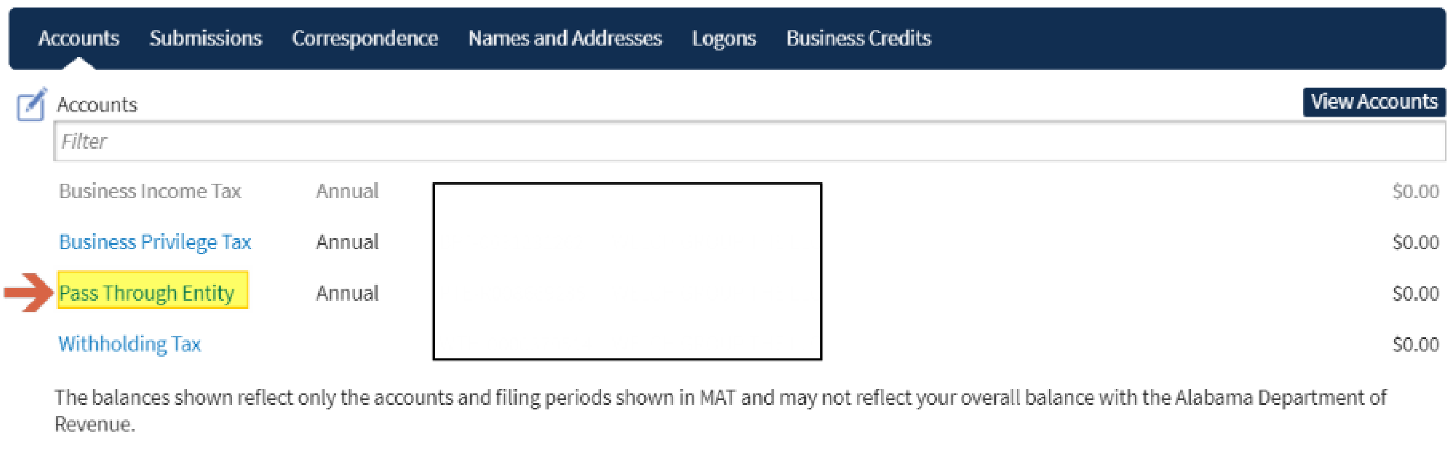
**Documentation (Step 6)**:
Be sure to document in writing the business rationale for your pass-through entity's donation to an SGO.

See Maynard Cooper memorandum, dated August 24, 2020, entitled "Final Regulations Relating to Business Expense Deductions and State Tax Credits for Donations to Charitable Organizations" for an overview of the Final Regulations (T.D. 9907 (Aug. 11, 2020)). The memo is not intended to be a complete description of the laws, rules or regulations and should not be relied on as legal or tax planning advice to any particular taxpayer without a full consideration of his, her or its specific facts and circumstances. Potential donors to Scholarship Granting Organizations should consult their own tax advisors prior to making any donation that might be claimed as a deductible expense.

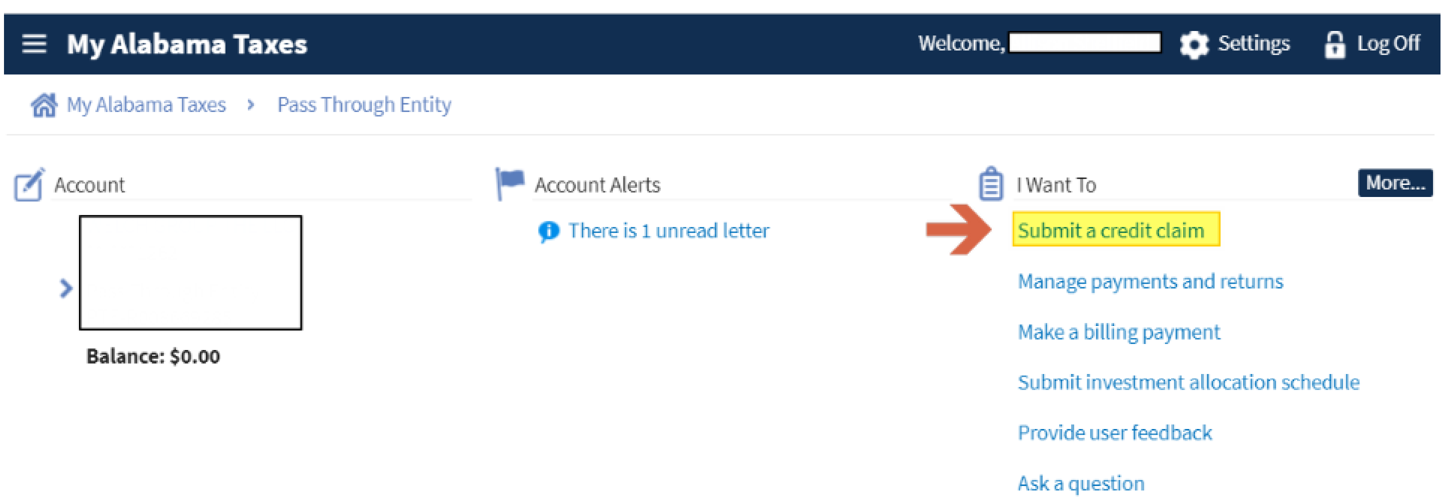
## Allocating Your Credit

The following additional steps must be completed by a Pass Thru Entity (PTE) after claiming the tax credit and receiving approval from the Scholarship Granting Organization (SGO).

1. To get started, log into your **MyAlabamaTaxes** account. Click on the **Pass Through Entity** link under the *Accounts* section.

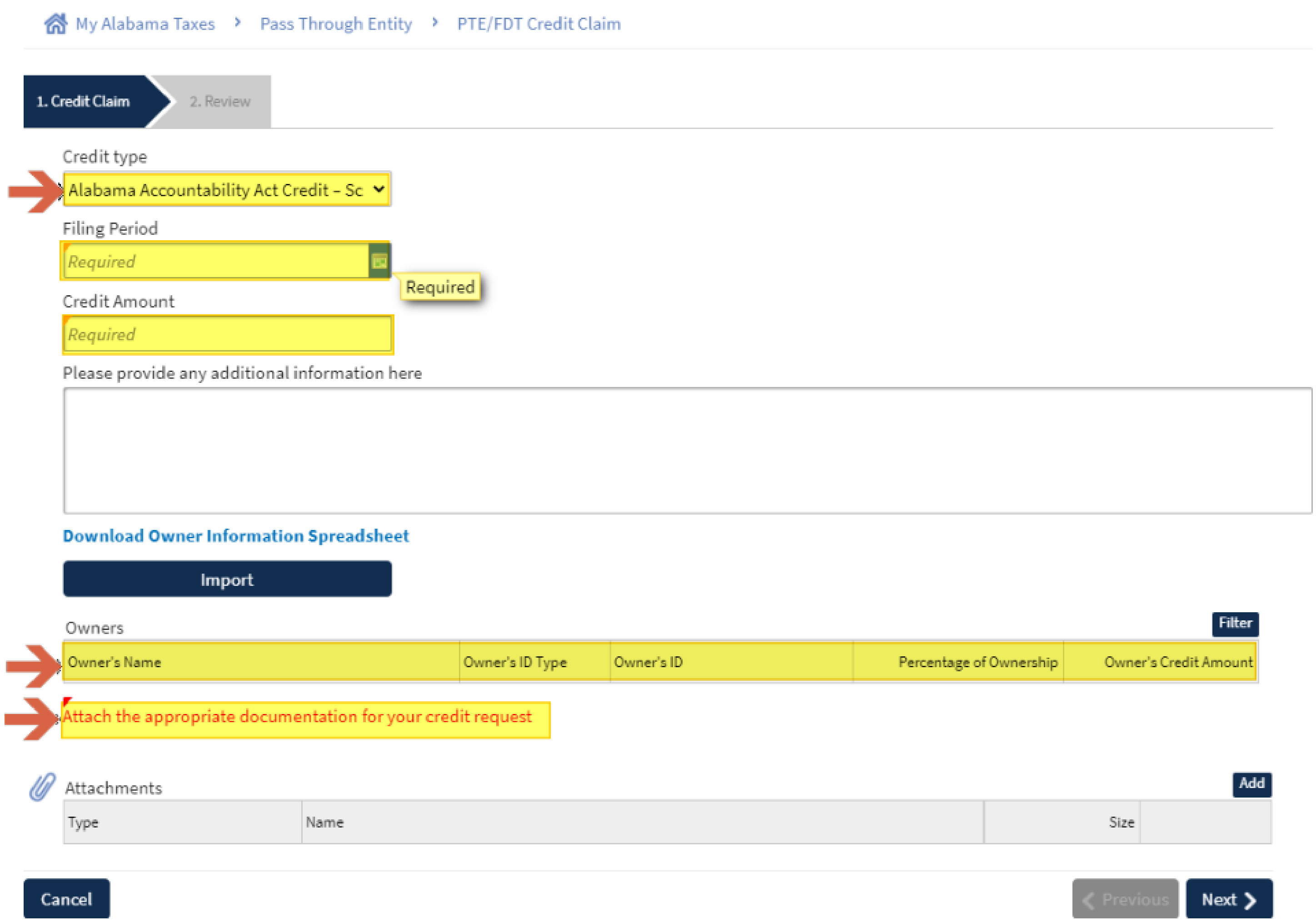



2. Click the ***Submit a credit claim*** link under the "*I Want To*" tab found on the right side of the screen.



3. Under ***Credit Type***, select *"Alabama Accountability Act Credit – Scholarship Granting Organization (SGO)"* from the dropdown box.

Next, complete the ***Filing Period***, ***Credit Amount,*** and provide the **Owner's information**. Be sure to **attach the confirmation letter received from the SGO**, then click next and confirm the information is correct.




Please consult your Financial Advisor or Tax Professional with any questions regarding the SGO process.

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# MEMORANDUM

**TO:** Cornerstone Schools

**FROM:** David H. Humber & Kyle M. Heslop

**RE:** Final Regulations Relating to Business Expense Deductions and State Tax Credits for Donations to Charitable Organizations

**DATE:** August 24, 2020

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On August 11, 2020, the United States Department of the Treasury (the "Treasury") released final regulations (the "Final Regulations") providing a potential avenue for an individual taxpayer to receive state and local tax ("SALT") credits as a result of a pass-through businesses entity's donation to a charitable organization that qualifies as business expense.[1] The Final Regulations suggest that by characterizing charitable donations by certain C corporations and specified pass-through business entities (collectively, "PTEs") as business expenses, PTEs can claim a federal income tax deduction for the donation at an entity-level, while the individual owners of such entities could apply the SALT credits generated by the PTEs' donations to reduce their individual state tax liability, providing possible relief from the $10,000 SALT deduction cap.[2]

This memo provides a brief overview of the Final Regulations and related laws, rules and regulations. In particular, this memo analyzes the impact of the Final Regulations on donations by C corporations and PTEs to scholarship granting organizations ("SGOs") under Alabama law.

## Background

Section 162(a) of the Internal Revenue Code (the "Code") provides a federal income tax deduction for all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. On the other hand, generally businesses and individuals deduct charitable contributions under Section 170 of the Code, because such deductions are generally not permitted to be classified as business expenses under Section 162 of the Code.[3] However, where all or a portion of a donation meets the Section 162 requirements described below, such qualifying amount can be deducted as a business expense instead of a charitable contribution.[4]

As mentioned above, contributions to charitable organizations are typically deductible by taxpayers under Section 170 of the Code, which allows a federal income tax deduction in the amount of such contribution, subject to certain limitations.[5] Section 170 deductions may only be taken by a taxpayer where the purpose of the contribution is purely charitable and in an amount that is limited by any consideration received by the taxpayer in exchange for the charitable gift.[6] Because of these limitations on Section 170 deductibility, where a taxpayer receives SALT credits from a state program in exchange for a donation to a charitable organization, the taxpayer may not take a Section 170 deduction for the amount of SALT credits received.[7]

Section 162 provides businesses a federal income tax deduction for certain donations of cash or cash equivalents made to charitable organizations[8] that qualify as reasonable business expenses.[9] Beneficially, Section 162 deductions do not share many of the same limitations as applied to deductions under Section 170 of the Code. To claim a Section 162 deduction for a charitable donation, (i) the donation must be a reasonable, ordinary and necessary expenditure made in carrying on a trade or business, (ii) the donation to the charitable organization must bear a "direct relationship to the taxpayer's trade or business" and (iii) the taxpayer must have "a reasonable expectation of financial return commensurate with the amount of the payment."[10]

In general, a deductible expenditure under Section 162 will be considered "ordinary and necessary," where the expenditure commonly occurs and is helpful in the development of the business being carried on.[11] Additionally, federal court decisions and federal agency guidance over the years have described various direct relationships that could qualify a charitable donation for a Section 162(a) deduction, including donations made for the purposes of advertising, name recognition and goodwill, improving neighborhoods and education systems to attract workers and customers, and improving employee health and morale.[12] The deductibility of any donation to a charitable organization under Section 162 of the Code will depend on the specific facts and circumstances relating to the donation, including the reasonableness of the amount of the donation and the business' reasonable expectation for a financial benefit.

The Alabama Accountability Act of 2013 (the "Accountability Act") provides individual and corporate taxpayers with a state income tax credit equal to the amount of any charitable contributions made to Alabama SGOs, subject to certain limitations.[13] In turn, SGOs administer educational scholarships to students currently attending failing schools to offset the costs of transferring the students to non-failing public or nonpublic schools. Under the Accountability Act, the state income tax credit generated by a PTE's donation to a charitable organization may be claimed by the individual owners of the PTE.[14]

**<u>The Final Regulations</u>**

The Final Regulations provide certain clarifications and safe harbors that depict a potential path to obtaining both a federal income tax deduction at an entity-level and individual tax credit for business owners where a donation from a PTE to a charitable organization generates a SALT credit pursuant to a state program. In doing so, the Final Regulations theoretically allow PTEs to avoid the disallowance of Section 170 federal income tax deductions where a charitable donation produces SALT credits.[15] In the Final Regulations, the Treasury specifically acknowledges the negative impact on donations to SGOs from the IRS's denial of Section 170 deductions where SALT credits are generated.[16]

The Final Regulations reiterate that to generate a Section 162 business expense deduction, a donation from a PTE to a charitable organization must meet all of the Section 162 qualifications as a reasonable, ordinary and necessary business expense.[17] While the qualifying business purpose of the donation will need to be determined on a case-by-case basis, the Final Regulations clarify that, to the extent that a PTE makes a donation to a charitable organization with an expectation that it will receive a corresponding SALT credit in return, "it is reasonable to conclude that there is a direct benefit and a reasonable expectation of commensurate financial return to the . . . specified [PTEs'] business in the form of a reduction in" SALT liability.[18] Thus, the Final Regulations seem to state that in most cases where SALT credits are expected to be received by the business, that Section 162 requirement is met for a charitable donation. However, the more the donating PTE can establish that the requirements of Section 162 are satisfied by the donation to the charitable organization, the more likely it will be that deductibility of the donation will be upheld if challenged.

Furthermore, the Final Regulations clarify that, where a charitable donation could qualify for a Section 162 deduction for federal income tax purposes, such classification does not affect the availability for an individual taxpayer to apply the generated SALT credits to its state tax liability, including where the SALT credits are passed through the business to its individual owners.[19] The Treasury provided the below example of how these principles work under the Final Regulations:

> *Example 2*. P, a partnership, operates a chain of supermarkets, some of which are located in State N. P operates a promotional program in which it sets aside the proceeds from one percent of its sales each year, which it pays to one or more charities described in section 170(c). The funds are earmarked for use in projects that improve conditions in State N. P makes the final determination on which charities receive payments. P advertises the program. P reasonably believes the program will generate a significant degree of name recognition and goodwill in the communities where it operates and thereby increase its revenue. As part of the program, P makes a $1,000 payment to a charity described in section 170(c). P may treat the $1,000 payment as an expense of carrying on a trade or business under section 162. This result is unchanged if, under State N's tax credit program, P expects to receive a $1,000 income tax credit on account of P's payment, and under State N law, the credit can be passed through to P's partners.[20]

For instance, if a PTE were to make a qualifying donation to an Alabama SGO, and the SGO were to use the donation to fund scholarships for inner-city students in an area that the PTE has a significant presence in order to allow those students to transfer from under-performing public schools to a qualified private school, the PTE has a reasonable basis to classify its donation as a deductible business expense for federal income tax purposes (provided that the donation met all of the Section 162 requirements, including being reasonable, ordinary and necessary) while also passing through the Alabama tax credit received by the PTE under the Accountability Act to its individual owners.

**Conclusion**

The Final Regulations provide a business with a potential avenue for reducing its federal income tax liability, while at the same time benefiting its individual owners by allowing the pass through of corresponding SALT credits. However, the Final Regulations do not provide a one-size-fits-all roadmap for deductibility of a PTE's donation to a charitable organization under Section 162 or for the availability to pass through SALT credits to a PTEs' individual owners. Instead, the availability of a Section 162 deduction and SALT credit pass-through are subject to meeting each requirement of Section 162 and the safe harbors described in the Final Regulations, and therefore should be analyzed in each case for compliance with such requirements.

*As this memo provides an overview of the Final Regulations and related laws, rules and regulations as of the date hereof, it is not intended to be a complete description of the laws, rules or regulations summarized herein. Therefore, this memo should not be relied on as legal or tax planning advice to any particular taxpayer without a full consideration of his, her or its specific facts and circumstances. Potential donors should consult their own tax advisors prior to making any donation that might be deductible under the laws, rules and regulations described in this memo.*

## Endnotes

[1] T.D. 9907 (Aug. 11, 2020).
[2] *Id.; see* I.R.C. § 164(b)(6). Pursuant to the Tax Cuts and Jobs Act, federal income tax deductions for SALTs paid by a taxpayer were capped at $10,000.
[3] *See* I.R.C. § 162(b).
[4] *See* I.R.C. § 162; T.D. 9907 at *8.
[5] I.R.C. § 170.
[6] *See id.*
[7] *See* Treas. Reg. § 1.170A-1(c)(5).
[8] Section 162 of the Code and the Final Regulations apply only to charitable organizations described in Section 170(c) of the Code, which includes, among other types of entities, corporations, trusts, funds or foundations "organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes."
[9] I.R.C. § 162(a).
[10] Treas. Reg. § 1.162-15(a).
[11] *See Welch v. Helvering*, 290 U.S. 111-113 (1993).
[12] *See, e.g.,* Treas. Reg. § 1.162-15(a) (examples 1 and 2); *United States v. Jefferson Mills, Inc.*, 367 F.2d 392 (5th Cir. 1966); *Marquis v. Comm'r*, 49 T.C. 695 (1968); *Boyd v. Comm'r*, T.C. Memo 2003-286; I.R.S. Rev. Rul. 63-73, 1963-1 C.B. 35; I.R.S. Rev. Rul. 72-134, 1972-1 C.B. 44; I.R.S. P.L.R. 9309006 (Mar. 5, 1993).
[13] *See* Ala. Code § 16-6D-9. The state income tax credit provided under Section 16-6D-9 is subject to certain limitations described therein, including, for individuals, that the credit not exceed 50% of the taxpayer's tax liability and is capped at $50,000 per tax year.
[14] *See* Ala. Code § 16-6D-9(a)(2).
[15] *Id.*; Treas. Reg. § 1.170A-1(h)(3); Rev. Proc. 2019-12, 2019-04 I.R.B. 401 (2018).
[16] T.D. 9907 at *11; ; Rev. Proc. 2019-12, 2019-04 I.R.B. 401 (2018).
[17] *See* Treas. Reg. § 1.162-15(a).
[18] T.D. 9907 at *8.
[19] *Id.* at *8-9.
[20] *Id.*