



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9907]

RIN 1545-BP40

Treatment of Payments to Charitable Entities in Return for Consideration

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under sections 162, 164, and 170 of the Internal Revenue Code (Code). First, the final regulations update the regulations under section 162 to reflect current law regarding the application of section 162 to taxpayers that make payments or transfers for business purposes to entities described in section 170(c). Second, the final regulations provide safe harbors under section 162 to provide certainty with respect to the treatment of payments made by business entities to entities described in section 170(c). Third, the final regulations provide a safe harbor under section 164 for payments made to an entity described in section 170(c) by individuals who itemize deductions and receive or expect to receive a State or local tax credit in return. Fourth, the final regulations update the regulations under section 170 to reflect past guidance and case law regarding the application of the quid pro quo principle under section 170 to a donor who receives or expects to receive benefits from a third party. These regulations affect taxpayers who make transfers to entities described in section 170(c) for business purposes, and taxpayers who receive State or

local tax credits in exchange for transfers to such entities or who receive other third-party benefits in exchange for transfers to such entities.

DATES: Effective date: These regulations are effective August 11, 2020.

Applicability dates: For dates of applicability, see §§1.162-15(a)(4), 1.164-3(j)(7), and 1.170A-1(h)(4)(iii).

FOR FURTHER INFORMATION CONTACT: Sarah Daya or Stephen Rothandler at (202) 317-4059 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

### **Background**

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 entity described in that section. Under section 170(c)(1), such an entity includes a State, a possession of the United States, or any political subdivision of the foregoing, or the District of Columbia. Entities described in section 170(c)(2) include 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) of the Income Tax Regulations 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 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 section 162(a) for any contribution or gift that would be allowable as a deduction under section 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payment set forth in that section.

Section 1.162-15(a) applies to contributions to entities described in section 170(c). Prior to amendment by this final regulation, §1.162-15(a)(1) provided that no deduction is allowable under section 162(a) for a contribution or gift by an individual or a corporation if any part thereof is deductible under section 170. For example, if a taxpayer makes a contribution of \$5,000 and only \$4,000 of this amount is deductible under section 170(a) (whether because of the percentage limitation under either section 170(b)(1) or (2), the requirement as to time of payment, or both), no deduction is allowable under section 162(a) for the remaining \$1,000. Section 1.162-15(a)(2) clarified that the limitations provided in section 162(b) and §1.162-15(a)(1) applied only to payments that are in fact contributions or gifts to organizations described in section 170. For example, payments by a transit company to a local hospital (which is a charitable organization within the meaning of section 170) in consideration of a binding obligation on the part of the hospital to provide hospital services and facilities for the company's employees are not contributions or gifts within the meaning of section 170

and may be deductible under section 162(a) if the requirements of section 162(a) are otherwise satisfied.

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 allows 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, under section 164(b)(5), taxpayers may elect to deduct 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 Public Law No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA), 131 Stat. 2054, 2085 (2017), provides, in the case of an individual, that deductions for foreign real property taxes are not allowable under section 164(a)(1), and that the deduction for the aggregate amount of the following State and local taxes paid during the calendar year is limited to \$10,000 (\$5,000 in the case of a married individual filing a separate return): (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 before January 1, 2026, 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 or accrued in carrying on a trade or business or an activity described in section 212. In response to the limitation in section 164(b)(6), some taxpayers have considered tax planning strategies to avoid or mitigate its effects.

Some of these strategies rely on State and local tax credit programs under which states provide tax credits in return for contributions by taxpayers to entities described in section 170(c), and some State and local governments have created new programs intended to facilitate use of these strategies.

On June 11, 2018, the Department of the Treasury (Treasury Department) and the IRS announced their intention to propose regulations addressing the proper application of sections 164 and 170 to taxpayers who make contributions under State and local tax credit programs to entities described in section 170(c). See Notice 2018-54, 2018-24 I.R.B. 750. On August 27, 2018, proposed regulations (REG-112176-18) under sections 170 and 642(c) were published in the **Federal Register** (83 FR 43563) (2018 proposed regulations). The 2018 proposed regulations proposed amending §1.170A-1(h)(3) to provide, in general, that if a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c), and the taxpayer receives or expects to receive a State or local tax credit in return for such payment or transfer, the tax credit constitutes a return benefit to the taxpayer and reduces the taxpayer's charitable contribution deduction. The 2018 proposed regulations also proposed amending regulations under section 642(c) to provide a similar rule for payments made by a trust or decedent's estate.

In response to the 2018 proposed regulations, commenters raised concerns regarding the treatment of business entity payments to entities described in section 170(c). The Treasury Department and the IRS considered these concerns and issued Rev. Proc. 2019-12, 2019-04 I.R.B. 401, on December 28, 2018, providing a safe harbor under section 162 for payments made by a C corporation or 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 State or local tax credits in return. Commenters also raised a concern regarding the treatment of payments by individuals who itemize deductions for Federal income tax purposes and who have total State and local tax liabilities that are less than or equal to the section 164(b)(6) limitation. The Treasury Department and the IRS addressed this concern by issuing Notice 2019-12, 2019-27 I.R.B. 57, on June 11, 2019, providing a safe harbor under section 164 for individuals who make payments to section 170(c) entities in return for State or local tax credits.

On June 13, 2019, the Treasury Department and the IRS published final regulations in the **Federal Register** (T.D. 9864, 84 FR 27513) (2019 final regulations) addressing the proper application of sections 164 and 170 to taxpayers who make contributions under State and local tax credit programs to entities described in section 170(c). The 2019 final regulations provided the general rule that, if a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c), and the taxpayer receives or expects to receive a State or local tax credit in return for such transfer, the tax credit constitutes a return benefit to the taxpayer, or quid pro quo, reducing the taxpayer's charitable contribution deduction. See §1.170A-1(h)(3). The 2019 final regulations also amended regulations under section 642(c) to provide a similar rule for payments made by a trust or decedent's estate.

On December 17, 2019, the Treasury Department and the IRS issued proposed regulations under sections 162, 164, and 170 (REG-107431-19, 84 FR 68833) to include the safe harbors provided under Rev. Proc. 2019-12 and Notice 2019-12, to

update regulations under section 162 to reflect current law regarding the application of section 162 to a taxpayer that makes a payment or transfer to an entity described in section 170(c) for a business purpose, and to clarify the application of the quid pro quo principle under section 170 to benefits received or expected to be received from third parties.

The Treasury Department and the IRS received over 40 comments responding to the proposed regulations and five requests to speak at the public hearing, which was held on February 20, 2020. Copies of written comments received and the list of speakers at the public hearing are available for public inspection at [www.regulations.gov](http://www.regulations.gov) or upon request.

## **Explanation of Provisions and Summary of Comments**

### *Explanation of Provisions*

The Treasury Department and the IRS adopt the proposed regulations with clarifications in response to the written comments received and testimony provided. First, the final regulations retain the proposed amendments to §1.162-15(a). The final regulations continue to clarify that a taxpayer's payment or transfer to a section 170(c) entity may constitute an allowable deduction as a trade or business expense under section 162, rather than a charitable contribution under section 170. The final regulations also retain the examples demonstrating the application of this rule with minor clarifying changes.

Second, the final regulations retain the safe harbors under section 162 to provide certainty with respect to the treatment of payments made by business entities to an entity described in section 170(c). The final regulations provide safe harbors under

section 162 for payments made by a business entity that is a C corporation or 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 State or local tax credits in return. To the extent that a C corporation or specified passthrough entity 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 and a reasonable expectation of commensurate financial return to the C corporation's or specified passthrough entity's business in the form of a reduction in the State or local taxes that the entity would otherwise be required to pay. Thus, the final regulations provide safe harbors that allow a C corporation or specified passthrough entity engaged in a trade or business to treat the portion of the payment that is equal to the amount of the credit received or expected to be received as meeting the requirements of an ordinary and necessary business expense under section 162. The safe harbors for C corporations and specified passthrough entities apply only to payments of cash and cash equivalents. The safe harbor for specified passthrough entities does not apply if the credit received or expected to be received reduces a State or local income tax.

Third, the final regulations retain the safe harbor under section 164 for payments made to an entity described in section 170(c) by individuals who itemize deductions and receive or expect to receive a State or local tax credit in return. The final regulations provide that an individual who itemizes deductions and who makes a payment to a section 170(c) entity in exchange for a State or local tax credit may treat as a payment of State or local tax for purposes of section 164 the portion of such payment for which a



charitable contribution deduction under section 170 is or will be disallowed under §1.170A-1(h)(3). This treatment is allowed in the taxable year in which the payment is made, but only to the extent that the resulting credit is applied pursuant to applicable State or local law to offset the individual's State or local tax liability for such taxable year or the preceding taxable year. Any unused credit permitted to be carried forward may be treated as a payment of State or local tax under section 164 in the taxable year or years for which the carryover credit is applied in accordance with State or local law. The safe harbor for individuals applies only to payments of cash and cash equivalents.

The final regulations are not intended to permit a taxpayer to avoid the limitation of section 164(b)(6). Therefore, the final regulations provide that any payment treated as a State or local tax under section 164, pursuant to the safe harbor provided in §1.164-3(j) of the final regulations, is subject to the limitation on deductions in section 164(b)(6). Furthermore, the final regulations are not intended to permit deductions of the same payments under more than one provision. Thus, the final regulations provide that an individual who relies on the safe harbor in §1.164-3(j) to deduct qualifying payments under section 164 may not also deduct the same payments under any other section of the Code.

Lastly, the final regulations retain the amendments to the regulations under section 170 to reflect past guidance and case law regarding the application of the quid pro quo principle under section 170 to a donor who receives or expects to receive benefits from a third party. The final regulations clarify that the quid pro quo principle applies regardless of whether the party providing the quid pro quo is the donee or a third party. To reflect existing law, the final regulations amend the rules in §1.170A-1(h)

that address a donor's payments in exchange for consideration. Specifically, the final regulations revise §1.170A-1(h)(4) to provide definitions of "in consideration for" and "goods and services" for purposes of applying the rules in §1.170A-1(h). Under the final regulations, a taxpayer will be treated as receiving goods and services in consideration for a taxpayer's payment or transfer to an entity described in section 170(c) if, at the time the taxpayer makes the payment or transfer, the taxpayer receives or expects to receive goods or services in return.

For additional clarity, the final regulations amend the language in §1.170A-1(h)(2)(i)(B) to state that the fair market value of goods and services includes the value of goods and services provided by parties other than the donee. Also, the final regulations add a definition of "goods and services" that is the same as the definition in §1.170A-13(f)(5). Finally, the final regulations revise the cross-references defining "in consideration for" and "goods and services" in §1.170A-1(h)(1) and (h)(3)(iii) to be consistent with the definitions provided in paragraph §1.170A-1(h)(4).

### *Summary of Comments*

#### 1. General Comments

As discussed previously in this preamble, the Treasury Department and the IRS received over 40 comments responding to the proposed regulations and five requests to speak at the public hearing. Approximately half of the commenters expressed support for the proposed regulations and recommended that the Treasury Department and the IRS finalize the proposed regulations. Many of these commenters expressed support for the clarification of the regulations under section 162 regarding business payments to section 170(c) entities and the incorporation of safe harbors previously provided in Rev.

Proc. 2019-12 and Notice 2019-12. However, some of these commenters expressed concerns about the impact of the 2019 final regulations on State and local programs granting tax credits for contributions by individuals and businesses to scholarship granting organizations (SGOs). SGOs are entities described in section 170(c) that receive contributions from individuals and businesses and then disburse these funds as scholarships to enable eligible students to attend qualified private schools. Additional commenters were concerned that, even with the clarifications in the proposed regulations, the 2019 final regulations have resulted in and will continue to result in decreased contributions to SGOs and other section 170(c) entities.

## 2. Payments by Business Entities in Exchange for State or Local Tax Credits

Multiple commenters expressed concern that passthrough entity owners may circumvent the section 164(b)(6) limitation by recharacterizing the portion of the payment that is not deductible under section 170 as a business expense deductible under section 162. One commenter requested clarification regarding whether a business entity may deduct payments to SGOs under section 162 as ordinary and necessary business expenses incurred in carrying on a trade or business. A few commenters expressed concern that the regulations may incentivize payments to education programs that discriminate against students with disabilities or that divert tax dollars from public schools to private schools. One commenter opined that State and local programs providing tax credits to businesses that donate to certain charitable organizations run counter to the concept of charity because donors should expect nothing in return for a donation.

Several commenters suggested revising Example 2 in §1.162-15(a)(2)(ii) to clarify that individuals are not allowed to generate partnership tax deductions under section 162 in addition to State or local tax credits that flow through to partners. Some commenters asserted that Example 2 is inconsistent with the safe harbor provided for passthrough entities in §1.162-15(a)(3), which expressly excludes situations in which passthrough entities receive State or local income tax credits. A commenter suggested including a general rule stating that in any case where a State or local tax credit has the effect of reducing an otherwise nondeductible State or local tax liability, the payment giving rise to the State or local tax credit cannot itself be deductible.

While the Treasury Department and the IRS acknowledge these concerns, the regulations retain the clarifications to §1.162-15(a)(1) and (a)(2) regarding section 162 deductions for business payments to section 170(c) entities, as well as examples illustrating the rule. Section 1.162-15(a)(1) mirrors the language of §1.170A-1(c)(5), which has been in effect since 1970. Section 1.170A-1(c)(5) provided that if the taxpayer's payment or transfer bears a direct relationship to its trade or business, and the payment is made with a reasonable expectation of commensurate financial return, the payment or transfer may constitute an allowable deduction as a trade or business expense under section 162, rather than a charitable contribution under section 170. See also Marquis v. Commissioner, 49 T.C. 695 (1968). Section 1.162-15(a)(1) applies the same standard. Thus, a passthrough entity may deduct a payment under §1.162-

15(a)(1) only if the entity can demonstrate that the payment satisfies these requirements, which limits the possibility of abuse.

Moreover, the revisions to §1.162-15(a)(1) are not inconsistent with the safe harbor provided for passthrough entities under §1.162-15(a)(3), which expressly excludes situations in which passthrough entities receive State or local income tax credits. The scope of §1.162-15(a)(3) is more limited because it provides safe harbor relief for taxpayers that receive a State or local tax credit in return for a payment to charity, rather than an application of the law. As a safe harbor, this section sets forth a simplified analysis of a passthrough entity's expenditure—requiring merely the receipt or expectation of receipt of a State or local business tax credit. In contrast, §1.162-15(a)(1) reiterates the current law, which requires more than the receipt of a credit against a business-related tax. Section 1.162-15(a)(1) requires a direct business relationship to the trade or business and a reasonable expectation of commensurate financial return. If a passthrough entity meets these requirements, then the payment or transfer to the section 170(c) entity may be properly treated as a business expense under section 162.

Another commenter also expressed concern that the examples under §1.162-15(a)(2) create confusion about deductions for institutional or “good will” advertising under §1.162-20(a)(2) because both examples contain facts that could describe advertising addressed in §1.162-20(a)(2). The commenter suggested that the examples be moved from §1.162-15(a)(2) to §1.162-20(a)(2). In addition, the commenter suggested that the Treasury Department and the IRS revise the examples to clarify the relationship between §1.162-15(a)(2) and §1.162-20(a)(2) and address the requirement

under §1.162-20(a)(2) that deductible institutional and good will advertising expenditures must relate to patronage that the taxpayer might reasonably expect in the future. This commenter also requested that the cross-reference to §1.162-20 in §1.162-15(d) of the existing regulations be modified to provide additional explanation.

The Treasury Department and the IRS considered these comments but have determined that changes to §1.162-15(a)(1) and (2) to clarify the distinctions between §1.162-15 and §1.162-20 are beyond the scope of these final regulations.

Section 1.162-20(a)(2) provides rules for deducting expenditures for institutional or good will advertising that keeps the taxpayer's name before the public, including by encouraging actions or presenting views on various subjects. For example, §1.162-20(a)(2) refers to the costs of advertising that encourages contributions to organizations such as the Red Cross, encourages the purchase of savings bonds, encourages participation in similar causes, or presents views on subjects of a general nature.

In contrast, §1.162-15(a) addresses only payments made to entities described in section 170(c). Section 1.162-15(a)(1) provides that payments to section 170(c) entities may be deducted under section 162 if they bear a direct relationship to the taxpayer's trade or business and are made with a reasonable expectation of financial return commensurate with the amount paid. The examples in §1.162-15(a)(2) of the final regulations are not intended to demonstrate the application of §1.162-20(a)(2), which serves a different purpose.

The final regulations revise Example 1 under §1.162-15(a)(2)(i) to refer to "supporters," rather than "sponsors," to avoid any potential confusion with the rules governing qualified sponsorship payments under section 513. In addition, the final

regulations revise the cross-reference in §1.162-15(d) to specify that the deductibility of expenditures for institutional and good will advertising is addressed in §1.162-20(a)(2).

### 3. Quid Pro Quo Provided by a Third Party

Some commenters expressed a belief that under current law a quid pro quo received or expected to be received by a taxpayer does not reduce the taxpayer's charitable contribution deduction if the quid pro quo comes from a party that is not the donee. The commenters emphasized that the use of State or local tax credits in exchange for donations to SGOs is not intended to subvert federal tax law. These commenters concluded that a tax credit from a State or local government should not reduce the charitable contribution deduction for a payment to a section 170(c)(2) entity. The commenters suggested that the quid pro quo principle should be applied only to contributions to entities described in section 170(c)(1). One commenter recommended that if a contribution is made to section 170(c)(2) entities in exchange for a State or local tax credit, the credit should be treated as income to the donor.

The Treasury Department and the IRS considered these comments, but did not adopt the suggested changes because the established tax law does not support them. As discussed in the preamble to the proposed regulations, both the courts and the IRS have concluded that the quid pro quo principle is equally applicable, regardless of whether the donor expects to receive the benefit from the donee or from a third party. See, e.g., Singer v. United States, 449 F.2d 413 (Ct. Cl. 1971) (rejecting the taxpayer's argument that an expected benefit should be ignored because it would be received from a third party); Rev. Rul. 67-246, 1967-2 C.B. 104 (concluding that the donor's charitable contribution deduction must be reduced by the value of a transistor radio provided by a

local store). Moreover, the courts have concluded that a taxpayer's expectation of a substantial benefit in return, from any source, reflects a lack of requisite charitable intent on the part of the donor. See, e.g., Ottawa Silica Co. v. United States, 699 F.2d 1124 (Fed. Cir. 1983) (denying a charitable contribution deduction for the value of land donated for the construction of a school, where the taxpayer had reason to believe such construction would ultimately increase the value of its land). Thus, the source of the consideration is immaterial in determining whether a donor has received or expects to receive a return benefit that reduces its charitable contribution deduction.

#### 4. Concerns About Reduced Charitable Giving

Several commenters expressed concerns about the impact of the regulations on donations to SGOs and other section 170(c)(2) entities that provide education opportunities for impoverished and special needs children in grades K-12. These commenters expressed concern that the 2019 final regulations have resulted in a decrease in donations to SGOs. Several commenters noted that these organizations improve the lives of students and criticized the proposed regulations as undermining the policy goals of school choice.

Some commenters stated that individual taxpayers should be able to claim a charitable contribution deduction for all payments made pursuant to a charitable State tax credit program. Other commenters suggested exempting payments and transfers to charitable entities if the payments and transfers are made pursuant to tax credit programs that were established before the enactment of the TCJA. Many commenters suggested providing an exception for State or local tax credits provided in exchange for payments to only non-governmental entities described under section 170(c). A few



commenters suggested revoking the 2019 final regulations or developing a more narrowly targeted approach.

As noted in the preamble to the 2019 final regulations, the Treasury Department and the IRS recognize the importance of the federal charitable contribution deduction, as well as State and local tax credit programs, in encouraging charitable giving. However, the concerns expressed by these commenters relate more directly to the 2019 final regulations, and the statutory limitation on individuals' deductions of State and local taxes under section 164, than to the amendments that are the subject of this rulemaking. The 2019 final regulations continue to allow a charitable contribution deduction for the portion of a taxpayer's contribution that is a gratuitous transfer, and do not affect the ability of states or localities to provide State or local tax incentives. In addition, the final regulations provide additional clarity to businesses that make payments or transfers to or for the use of SGOs and other entities described in section 170(c). Similarly, the safe harbor provided under §1.164-3(j) of the final regulations for individuals who itemize deductions will ensure equitable treatment for taxpayers whose deductions for State and local tax payments would not have exceeded the section 164(b)(6) limitation.

In addition, for the reasons cited in the preamble to the 2019 final regulations, those regulations do not distinguish between taxpayers who make payments or transfers to State and local tax credit programs established after enactment of the TCJA and those who make payments or transfers to credit programs established prior to the enactment of the TCJA. Similarly, these final regulations apply the quid pro quo principle under section 170 equally to all State and local tax credit programs, and the

final regulations do not adopt commenter recommendations to create exceptions for various types of State tax credit programs.

### **Applicability Dates**

The amendments to §1.162-15 apply to payments or transfers made on or after December 17, 2019. However, taxpayers may choose to apply the amendments to payments or transfers made on or after January 1, 2018.

Section 1.164-3(j) applies to payments made to section 170(c) entities on or after June 11, 2019. However, taxpayers may choose to apply paragraph (j) to payments made to section 170(c) entities after August 27, 2018.

The definitions provided in §1.170A-1(h)(4) are applicable to amounts paid or property transferred on or after December 17, 2019.

### **Special Analyses**

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility. The Administrator of the Office of Information and Regulatory Affairs (OIRA), Office of Management and Budget, has waived review of this rule in accordance with section 6(a)(3)(A) of Executive Order 12866.

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this rule will not have a significant economic impact on a substantial number of small entities. Although data are not readily available for the IRS and the

Treasury Department to assess the number of small entities that are likely to be directly affected by the regulations, the economic impact is unlikely to be significant.

As discussed elsewhere in this preamble, the rule largely updates the regulations to reflect existing law and policy. The amendments update the section 162 and section 170 regulations to reflect current law. In addition, the amendments add to the regulations safe harbors under section 162 and section 164, regarding deductions when payments are made to entities described in section 170(c) and the donor receives or expects to receive a State or local tax credit in return; these safe harbors were provided previously in Internal Revenue Bulletin guidance. These regulations are expected to provide some additional certainty to taxpayers but are not expected to result in any noticeable change in taxpayer behavior. The increased certainty, and in particular the provision of safe harbors, is expected to reduce compliance burdens. Accordingly, the Treasury Department and the IRS certify that the rule will not have a significant economic impact on a substantial number of small entities. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

#### **Statement of Availability of IRS Documents**

IRS Revenue Procedures, Revenue Rulings, Notices, and other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at <http://www.irs.gov>.

## **Drafting Information**

The principal author of these regulations is the Office of the Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and the Treasury Department participated in their development.

## **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

## **Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

### **PART 1—INCOME TAXES**

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.162-15 is amended by revising paragraphs (a) and (d) to read as follows:

#### §1.162-15 Contributions, dues, etc.

(a) Payments and transfers to entities described in section 170(c)—(1) In general. A payment or transfer to or for the use of an entity described in section 170(c) that bears a direct relationship to the taxpayer's trade or business and that is made with a reasonable expectation of financial return commensurate with the amount of the payment or transfer may constitute an allowable deduction as a trade or business expense rather than a charitable contribution deduction under section 170. For payments or transfers in excess of the amount deductible under section 162(a), see §1.170A-1(h).

(2) Examples. The following examples illustrate the rules of paragraph (a)(1) of this section:

(i) Example 1. A, an individual, is a sole proprietor who manufactures musical instruments and sells them through a website. A makes a \$1,000 payment to a local church (which is a charitable organization described in section 170(c)) for a half-page advertisement in the church's program for a concert. In the program, the church thanks its concert supporters, including A. A's advertisement includes the URL for the website through which A sells its instruments. A reasonably expects that the advertisement will attract new customers to A's website and will help A to sell more musical instruments. A may treat the \$1,000 payment as an expense of carrying on a trade or business under section 162.

(ii) 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.

(3) Safe harbors for C corporations and specified passthrough entities making payments in exchange for State or local tax credits—(i) Safe harbor for C corporations.

If a C corporation makes a payment to or for the use of an entity described in section 170(c) and receives or expects to receive in return a State or local tax credit that reduces a State or local tax imposed on the C corporation, 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 amount of the credit received or expected to be received.

(ii) Safe harbor for specified passthrough entities—(A) Definition of specified passthrough entity. For purposes of this paragraph (a)(3)(ii), an entity is a specified passthrough entity if each of the following requirements is satisfied—

(1) The entity is a business entity other than a C corporation and is regarded for all Federal income tax purposes as separate from its owners under §301.7701-3 of this chapter;

(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 entity described in section 170(c), the entity described in paragraph (a)(3)(ii)(A)(1) of this section 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 paragraph (a)(3)(ii)(A)(3) of this section.

(B) Safe harbor. Except as provided in paragraph (a)(3)(ii)(C) of this section, if a specified passthrough entity makes a payment to or for the use of an entity described in section 170(c), and receives or expects to receive in return a State or local tax credit that reduces a State or local tax described in paragraph (a)(3)(ii)(A)(3) of this section, the specified passthrough entity may treat such payment as an ordinary and necessary business expense for purposes of section 162(a) to the extent of the amount of credit received or expected to be received.

(C) Exception. The safe harbor described in this paragraph (a)(3)(ii) does not apply if the credit received or expected to be received reduces a State or local income tax.

(iii) Definition of payment. For purposes of this paragraph (a)(3), payment is defined as a payment of cash or cash equivalent.

(iv) Examples. The following examples illustrate the rules of paragraph (a)(3) of this section.

(A) Example 1. C corporation that receives or expects to receive dollar-for-dollar State or local tax credit. A, a C corporation engaged in a trade or business, makes a payment of \$1,000 to an entity described in section 170(c). In return for the payment, A expects to receive a dollar-for-dollar State tax credit to be applied to A's State corporate income tax liability. Under paragraph (a)(3)(i) of this section, A may treat the \$1,000 payment as an expense of carrying on a trade or business under section 162.

(B) Example 2. C corporation that receives or expects to receive percentage-based State or local tax credit. B, a C corporation engaged in a trade or business, makes a payment of \$1,000 to an entity described in section 170(c). In return for the payment, B expects to receive a local 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 paragraph (a)(3)(i) of this section, B may treat \$800 as an expense of carrying on a trade or business under section 162. The treatment of the remaining \$200 will depend upon the facts and circumstances and is not affected by paragraph (a)(3)(i) of this section.

(C) Example 3. Partnership that receives or expects to receive dollar-for-dollar State or local tax credit. P is a limited liability company classified as a partnership for Federal income tax purposes under §301.7701-3 of this chapter. P is engaged in a trade or business and makes a payment of \$1,000 to an entity described in section 170(c). In return for the payment, P 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 paragraph (a)(3)(ii) of this section, P may treat the \$1,000 as an expense of carrying on a trade or business under section 162.

(D) Example 4. S corporation that receives or expects to receive percentage-based State or local tax credit. 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 entity described in section 170(c). In return for the payment, S expects to receive a local 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 local law, the real property tax is imposed at the entity level (not the owner level). Under paragraph (a)(3)(ii) of this section, S may treat \$800 of the payment as an expense of carrying on a trade or business under section 162. The treatment of the remaining \$200 will depend upon the facts and circumstances and is not affected by paragraph (a)(3)(ii) of this section.

(v) Applicability of section 170 to payments in exchange for State or local tax benefits. For rules regarding the availability of a charitable contribution deduction under section 170 where a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c) and receives or expects to receive a State or local tax benefit in return for such payment, see §1.170A-1(h)(3).

(4) Applicability dates. Paragraphs (a)(1) and (2) of this section, regarding the application of section 162 to taxpayers making payments or transfers to entities described in section 170(c), apply to payments or transfers made on or after December 17, 2019. Section 1.162-15(a), as it appeared in the April 1, 2020 edition of 26 CFR part 1, generally applies to payments or transfers made prior to December 17, 2019. However, taxpayers may choose to apply paragraphs (a)(1) and (2) of this section to payments and transfers made on or after January 1, 2018. Paragraph (a)(3) of this section, regarding the safe harbors for C corporations and specified passthrough entities making payments to section 170(c) entities in exchange for State or local tax credits, applies to payments made by these entities on or after December 17, 2019. However, taxpayers may choose to apply the safe harbors of paragraph (a)(3) to payments made on or after January 1, 2018.

\* \* \* \* \*

(d) Cross reference. – For provisions dealing with expenditures for institutional or “good will” advertising, see §1.162-20(a)(2).

Par. 3. Section 1.164-3 is amended by adding paragraph (j) to read as follows:

§1.164-3 Definitions and special rules.

\* \* \* \* \*



(j) Safe harbor for payments made by individuals in exchange for State or local tax credits--(1) In general. An individual who itemizes deductions and who makes a payment to or for the use of an entity described in section 170(c) in consideration for a State or local tax credit may treat as a payment of State or local tax for purposes of section 164 the portion of such payment for which a charitable contribution deduction under section 170 is disallowed under §1.170A-1(h)(3). This treatment as payment of a State or local tax is allowed in the taxable year in which the payment is made to the extent that the resulting credit is applied, consistent with applicable State or local law, to offset the individual's State or local tax liability for such taxable year or the preceding taxable year.

(2) Credits carried forward. To the extent that a State or local tax credit described in paragraph (j)(1) of this section is not applied to offset the individual's applicable State or local tax liability for the taxable year of the payment or the preceding taxable year, any excess State or local tax credit permitted to be carried forward may be treated as a payment of State or local tax under section 164(a) in the taxable year or years for which the carryover credit is applied in accordance with State or local law.

(3) Limitation on individual deductions. Nothing in this paragraph (j) may be construed as permitting a taxpayer who applies this safe harbor to avoid the limitation of section 164(b)(6) for any amount paid as a tax or treated under this paragraph (j) as a payment of tax.

(4) No safe harbor for transfers of property. The safe harbor provided in this paragraph (j) applies only to a payment of cash or cash equivalent.

(5) Coordination with other deductions. An individual who deducts a payment under section 164 may not also deduct the same payment under any other Code section.

(6) Examples. In the following examples, the taxpayer is an individual who itemizes deductions for Federal income tax purposes.

(i) Example 1. In year 1, Taxpayer A makes a payment of \$500 to an entity described in section 170(c). In return for the payment, A receives a dollar-for-dollar State income tax credit. Prior to application of the credit, A's State income tax liability for year 1 was more than \$500. A applies the \$500 credit to A's year 1 State income tax liability. Under paragraph (j)(1) of this section, A treats the \$500 payment as a payment of State income tax in year 1. To determine A's deduction amount, A must apply the provisions of section 164 applicable to payments of State and local taxes, including the limitation in section 164(b)(6). See paragraph (j)(3) of this section.

(ii) Example 2. In year 1, Taxpayer B makes a payment of \$7,000 to an entity described in section 170(c). In return for the payment, B receives a dollar-for-dollar State income tax credit, which under State law may be carried forward for three taxable years. Prior to application of the credit, B's State income tax liability for year 1 was \$5,000; B applies \$5,000 of the \$7,000 credit to B's year 1 State income tax liability. Under paragraph (j)(1) of this section, B treats \$5,000 of the \$7,000 payment as a payment of State income tax in year 1. Prior to application of the remaining credit, B's State income tax liability for year 2 exceeds \$2,000. B applies the excess credit of \$2,000 to B's year 2 State income tax liability. For year 2, under paragraph (j)(2) of this section, B treats the \$2,000 as a payment of State income tax under section 164. To determine B's deduction amounts in years 1 and 2, B must apply the provisions of section 164 applicable to payments of State and local taxes, including the limitation under section 164(b)(6). See paragraph (j)(3) of this section.

(iii) Example 3. In year 1, Taxpayer C makes a payment of \$7,000 to an entity described in section 170(c). In return for the payment, C receives a local real property tax credit equal to 25 percent of the amount of this payment (\$1,750). Prior to application of the credit, C's local real property tax liability in year 1 was more than \$1,750. C applies the \$1,750 credit to C's year 1 local real property tax liability. Under paragraph (j)(1) of this section, for year 1, C treats \$1,750 of the \$7,000 payment as a payment of local real property tax for purposes of section 164. To determine C's deduction amount, C must apply the provisions of section 164 applicable to payments of State and local taxes, including the limitation under section 164(b)(6). See paragraph (j)(3) of this section.

(7) Applicability date. This paragraph (j) applies to payments made to section 170(c) entities on or after June 11, 2019. However, a taxpayer may choose to apply this paragraph (j) to payments made to section 170(c) entities after August 27, 2018.

Par. 4. Section 1.170A-1 is amended as follows:

1. Paragraph (c)(5) is revised.
2. In paragraph (h)(1) introductory text, remove the cross-references to “§1.170A-13(f)(6)” and “§1.170A-13(f)(5)” and add in their places “paragraph (h)(4)(i) of this section” and “paragraph (h)(4)(ii) of this section”, respectively.
3. Paragraphs (h)(2)(i)(B) and (h)(3)(iii) are revised.
4. Paragraph (h)(3)(viii) is redesignated as paragraph (h)(3)(x).
5. New paragraph (h)(3)(viii) and paragraph (h)(3)(ix) are added.
6. Paragraphs (h)(4) through (6) are redesignated as paragraphs (h)(5) through (7).
7. New paragraph (h)(4) is added.

The revisions and additions read as follows:

§1.170A-1 Charitable, etc., contributions and gifts; allowance of deduction.

\* \* \* \* \*

(c) \* \* \*

(5) For payments or transfers to an entity described in section 170(c) by a taxpayer carrying on a trade or business, see §1.162-15(a).

\* \* \* \* \*

(h) \* \* \*

(2) \* \* \*

(i) \* \* \*

(B) The fair market value of the goods or services received or expected to be received in return.

\* \* \* \* \*

(3) \* \* \*

(iii) In consideration for. For purposes of paragraph (h) of this section, the term in consideration for has the meaning set forth in paragraph (h)(4)(i) of this section.

\* \* \* \* \*

(viii) Safe harbor for payments by C corporations and specified passthrough entities. For payments by a C corporation or by a specified passthrough entity to an entity described in section 170(c), where the C corporation or specified passthrough entity receives or expects to receive a State or local tax credit that reduces the charitable contribution deduction for such payments under paragraph (h)(3) of this section, see §1.162-15(a)(3) (providing safe harbors under section 162(a) to the extent of that reduction).

(ix) Safe harbor for individuals. Under certain circumstances, an individual who itemizes deductions and makes a payment to an entity described in section 170(c) in consideration for a State or local tax credit may treat the portion of such payment for which a charitable contribution deduction is disallowed under paragraph (h)(3) of this section as a payment of State or local taxes under section 164. See §1.164-3(j), providing a safe harbor for certain payments by individuals in exchange for State or local tax credits.

\* \* \* \* \*

(4) Definitions. For purposes of this paragraph (h), the following definitions apply:

(i) In consideration for. A taxpayer receives goods or services in consideration for a taxpayer's payment or transfer to an entity described in section 170(c) if, at the time the taxpayer makes the payment to such entity, the taxpayer receives or expects to receive goods or services from that entity or any other party in return.

(ii) Goods or services. Goods or services means cash, property, services, benefits, and privileges.

(iii) Applicability date. The definitions provided in this paragraph (h)(4) are applicable to amounts paid or property transferred on or after December 17, 2019.

\* \* \* \* \*

§1.170A-13 [Amended]

Par. 5. Section 1.170A-13 is amended in paragraph (f)(7) by removing the cross-reference “§1.170A-1(h)(5)” and adding in its place “§1.170A-1(h)(6)”.

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

Approved: July 27, 2020.

David J. Kautter,

Assistant Secretary of the Treasury (Tax Policy).