Irony at the IRS: Cracking Down on Blue State Tactic Borrowed From Red State Playbook

The Treasury Department and the Internal Revenue Service are not particularly well-known for their sense of irony. But in August, things took a turn in that direction when the two agencies suggested new rules that crack down on states that try to circumvent the "SALT-cap," a provision of the new Republican-backed Tax Cuts and Jobs Act of 2017 that prevents wealthy taxpayers from writing off more than $10,000 of state and local taxes when filling out their federal tax forms. The circumventions, which are concentrated in Democrat-controlled states with higher taxes, are modelled on "neovouchers"—state policies that offer tax credits in exchange for donations to non-profits that bundle the donations into vouchers that pay for private school tuition. In a nutshell, the blue states learned a trick from the red states, so the IRS is now compelled to step in and put an end to all the mischief. Though designed to target the provisions recently adopted by blue states, the new IRS/Treasury rules could also curtail a program popular on the other side of the aisle.

As NEPC director Kevin Welner writes in this policy memo, neovouchers were created by Republicans to make an end run around state constitutions that prohibit public funds from flowing directly to private, religious schools. They mirror the effect of direct governmental spending, but the money never actually finds its way into state coffers.

Carl Davis is a tax policy expert who is the research director at the Institute on Taxation and Economic Policy, a non-profit, non-partisan organization that conducts analyses of tax and economic proposals and provides data-driven recommendations on how to shape equitable and sustainable tax systems. For years, Davis has been in the forefront of tax issues around neovouchers, documenting the unusually generous benefits that wealthy taxpayers can gain from the laws, and now documenting the IRS/Treasury response to the SALT-cap laws in blue states. In this Q & A with NEPC, he sheds light on the proposed rules and on some of the issues raised by Welner's memo.

Questions:

1. Quickly, before our readers see "tax law" and run away: What do typical taxpayers, especially those with an interest in K-12 education, most need to understand about the debate? Why should they care?

Right now the tax system is being used to pay off rich people who steer public dollars into private K-12 school voucher programs. It's an egregious tax shelter and it's fueling the growth of neovoucher programs in many states. The tax rewards associated with "donating" to support school vouchers have become so supersized that they're attracting not just people who genuinely want to support private and religious schools, but also a whole slew of opportunists who are just looking to make a buck. Ultimately the money flowing into these neovoucher programs—and into the opportunists' pockets—is coming out of state and federal coffers, meaning that there are fewer resources left over to support public education and other public services.

2. Can you give us a sense of the size of the impact of neovouchers on state revenues?

Nationwide, these neovoucher programs are draining over $1 billion annually from state revenue streams, and that loss is growing rapidly. In Florida, the program automatically grows by 25 percent per year, while one of Arizona's programs grows by 20 percent annually. Lawmakers in Arizona and Georgia, meanwhile, recently expanded their highly-controversial programs via legislation.

3. How have wealthy taxpayers been able to take advantage of state neovoucher laws in the past?

The short version is that neovoucher "donors" are getting most, or all, of their "donations" reimbursed by their state governments, and yet they're writing off these "donations" as if they were genuine charitable gifts when they fill out their federal tax forms. By stacking federal tax breaks on stop of state tax breaks, many wealthy families have been able to reap tax rewards larger than their actual donations. They're turning a profit at taxpayer expense.

To elaborate a bit: The state neovoucher laws take a familiar idea—charitable giving tax incentives—and inflate them to the point of absurdity. It's very common for states to offer their residents a tax break when they donate to support charitable causes. Usually, that break is worth about 5 or 10 cents on the dollar. Somebody donating $100 to a local homeless shelter, for example, might save $5 or $10 on their state tax bill.

A donation under a neovoucher program, by contrast, often earns the donor a tax break of between 75 and 100 cents on the dollar. In other words, somebody "donating" $100 to fund private K-12 school vouchers is saving $75 or $100 on their state tax bill. The result is that most, or all, of the money isn't really coming out of the so-called "donor's" pocket at all. It's coming out of the state's budget.

In effect, these states have decided that they're going to treat private school voucher donors much more favorably than the people who prefer to give their money to homeless shelters, or veterans groups, or almost any other cause.

The tax shelter comes into play when these donors claim not just a state neovoucher tax credit, but also a federal-level charitable deduction. The donors are already getting their money back from their state government, and yet they're writing off these so-called "donations" on their federal tax forms nonetheless.

This problem stems from the fact that Congress never envisioned states enacting charitable giving incentives as large as these neovouchers. There's a blind spot in the federal tax code surrounding state tax credits. There's no mechanism for recognizing when a taxpayer actually saw their donation reimbursed with a state tax credit, and thus the IRS has always treated these donations as genuine charitable gifts.

The tax shelter varies by state and by taxpayer, but for a high-income person claiming both a state neovoucher credit and the maximum federal charitable deduction, it's not uncommon for a $10,000 "donation" to yield about $13,700 in tax cuts. That's a 37 percent profit just for filling out some paperwork, and it can be repeated year after year. It's the exact opposite of genuine charity.

In some states, the profits can be even larger. The average donation by a business under Arizona's neovoucher program, for example, was over $120,000 this year. A donation of that size could potentially yield tens of thousands of dollars in annual profits for the donor.

4. How, if at all, did the Tax Cuts and Jobs Act of 2017 change the potential for wealthy taxpayers to take advantage of state neovoucher laws?

The new federal tax law treats charitable giving much more favorably than payments of state and local taxes (SALT). For high-income taxpayers, charitable giving is deductible almost without limit, whereas SALT payments are only deductible up to the first $10,000 paid.

The predictable result of this discrepancy is that high-income taxpayers would much rather make a charitable gift than pay a tax. If you make a donation to support private schools, that donation will likely be fully deductible. If you make a tax payment to support public schools, you won't receive any further deduction if you're already above the $10,000 cap.

What's happening now is that accountants in Alabama, Arizona, Georgia, and elsewhere are telling their clients: you'd be foolish to pay your state taxes now, and you should make a donation to one of these neovoucher programs instead. This was already happening to some extent before last year's federal tax overhaul was enacted, but the problem has been made much worse by the new law. Taxpayers in Alabama and Arizona, for instance, responded in a particularly dramatic fashion to the expanded federal tax avoidance opportunity. Both states saw their neovoucher credits claimed at record speed this year, with Arizona's $89 million neovoucher for businesses being claimed in full in just two minutes.

5. How might the new IRS/Treasury regulations change the potential for wealthy taxpayers to take advantage of state neovoucher laws?

The proposed regulations would inject a welcome bit of common sense into the federal tax code's measurement of real charity. If you donate and then get all your money back in state tax credits, then you haven't actually done anything charitable and you will no longer receive a federal charitable deduction. If you donate and get half of your money back in state tax credits, then you can only deduct the other half of your donation—the part that was not reimbursed.

Wealthy taxpayers are still going to receive very large state tax credits when they contribute to neovoucher programs. But under these regulations, the federal tax benefits of contributing would be drastically reduced or eliminated. People who are only participating in the programs to reap a profit for themselves will suddenly drop out of the donor pool, as the reduced federal tax benefits cause those profits to evaporate.

6. IRS/Treasury recently released a clarification on the proposed rules. How and why did that clarification come about? What does it say and how might it impact the rule's effect on neovouchers?

The clarification appears to have been a pet project of Sen. Pat Toomey (R-PA). Sen. Toomey's home state of Pennsylvania has one of the largest neovoucher programs in the country, and he helped convinced the IRS and Treasury Department to issue parallel statements suggesting that business owners could get around the new regulations by writing off their donations to neovoucher programs as "business expenses" rather than "charitable gifts."

These statements caught most tax policy experts by surprise, and they seem to partly undercut the good work the IRS is doing overall on this topic.

In his release, Treasury Secretary Steven Mnuchin specifically referred to "business-related donations to school choice programs." But right now it's unclear how difficult it will be for businesses to prove whether their neovoucher donations are truly "business-related," which has a technical meaning in the tax law.

In short, the so-called "clarification" has created more confusion than clarity. The IRS needs to elaborate on when it plans to allow businesses to write off their donations as business expenses. As things currently stand, it seems that some businesses may be able to keep turning a profit on their neovoucher donations if they can stack state neovoucher credits and federal business expense deductions on top of each other. The clarification doesn't answer this question definitively, but it indicates that the IRS may look the other way when reviewing these types of transactions.

7. What are the odds that the new rules will be approved?

There is no doubt that a regulation on this broad topic (state tax credits received in return for making charitable gifts) will be finalized, but whether the final regulation will include neovouchers within its scope remains in doubt. Some of the largest school choice groups, including the American Federation for Children and EdChoice, harshly criticized the regulations upon their release. Private school advocates across the country have also been writing official comments to the IRS asking that their programs be exempted from the regulations.

On the other hand, many public education advocates have been making the case that the IRS should reject those appeals. The regulations as currently drafted are even-handed, meaning that they don't include special rules and exceptions for donations to certain types of causes. I'm hopeful that the IRS will stick to its principles, but we won't know for sure until we see the final regulations. Final regulations are expected late this year or early next year, just in time for people who have made these donations to know how to fill out their 2018 tax forms.

8. Would you expect legal challenges? If so, what are the issues that might be framed by any litigation?

The main reason the IRS is pursuing this effort right now is that a handful of blue states (New York, New Jersey, Connecticut, and Oregon) recently took note of the neovoucher tax shelter, and decided to adapt it to their own purposes. Specifically, these states are encouraging taxpayers to make "donations" (rather than tax payments) to support public education and public health, and to reap a hefty federal tax cut in the process. If these blue-state efforts stand, the potential federal revenue loss would be enormous, which is why we know for a fact that regulations on this topic will be finalized. The IRS will not allow such an enormous tax shelter to spread without at least putting up a fight.

New Jersey's attorney general has already indicated that he is likely to challenge the IRS regulations in court. His argument will likely hinge on the fact that the IRS is departing from its past treatment of donations benefiting from state charitable tax credits. For years, the IRS simply ignored those credits. Some lawmakers in New Jersey would like the IRS to keep ignoring them. I think that would be a mistake.

Federal agencies are usually given fairly broad discretion in interpreting the law, so New Jersey and any other state challenging these regulations will face an uphill battle in court. But the outcome is impossible to predict with certainty.

9. In the end, what do you expect the federal rules to do with regard to wealthy taxpayers taking advantage of state neovoucher laws?

I'm hopeful that the tax shelter being exploited by neovoucher donors will be shut down or at least drastically curtailed. The biggest danger right now is that private school groups might succeed in slipping a carveout into the regulations before they are finalized late this year or early next year. They know that it's a lot easier to raise money for their cause when they can promise their so-called "donors" a profit in exchange for their donations.

It's important that the IRS reject those calls for a carveout. If they do, then we're likely to see a good outcome on the neovoucher question.

After the regulations are finalized, the only remaining obstacles are a potential court challenge from New Jersey and a possible push from school choice supporters in Congress to enact a carveout via legislation. But the regulations have a good chance of holding up in court, and I find it very doubtful that Congress could muster support to reopen this tax shelter for private school donors anytime soon.

10. What is the key message that you believe the IRS needs to hear?

The key message that I believe the IRS needs to hear is that it should reject calls to include a special carveout for neovouchers as it finalizes these regulations. I find the proposed regulations to be principled and even-handed. Watering them down with special exceptions for people who donate to particular causes—including private K-12 school voucher programs—would be unfair and unnecessarily complex. We know for a fact that tax accountants and private schools have been advising taxpayers that neovoucher programs provide a lucrative federal tax shelter. This is the perfect opportunity to shut that tax shelter down. There's no reason for the IRS to turn a blind eye to this loophole at this pivotal moment.

11. If our readers are interested in impacting the outcome of the IRS/Treasury proposed rules, or even just learning more about the debate, what actions would you recommend taking? What resources would you recommend reviewing?

The most important thing that public education advocates and interested individuals can do is to submit a public comment to the IRS before the October 11 deadline. The online comment form is fairly simple and can be accessed here.

Individuals interested in commenting can type their comment directly into the website. Organizations that wish to comment should consider putting their comment on their official letterhead and uploading it as a PDF.

Anyone who may be near Washington, DC on November 5th should also consider requesting to speak at the official public hearing on this topic being hosted by the IRS.

For anyone interested in learning more about this subject, ITEP has a list of resources available online here.

NEPC Resources on Neovouchers:

How Voucher Advocates Created a Blue-State Loophole to Trump's Tax Law

How to Calculate the Costs or Savings of Tax Credit Voucher Policies

The Neovoucher: A Kissing Cousin in Disguise

Under the Voucher Radar

For those of you in the DC region, please don't forget to RSVP for AERA's Brown lecture, given this year by NEPC Fellow and Vanderbilt professor Rich Milner. His talk is titled, Disrupting Punitive Practices and Policies: Rac(e)ing Back to Teaching, Teacher Preparation, and Brown, and it will be on Oct. 25th at 6pm. RSVP here.

NEPC Resources on Tuition Tax Credits

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