Update on Federal Tax Law Changes and Tax Treatment of Certain Georgia State Tax Credits

The recent federal tax reform bears potential opportunities and challenges for taxpayers across the country when it comes to determining their federal and state income tax liabilities. As a result, many taxpayers who may have never considered participating in certain state income tax credit programs might now contemplate what options are available to them due to the limitation on the federal deduction for state and local taxes. Georgia for example, currently offers a multitude of state tax credit incentive programs in which taxpayers may participate. However, on May 23, 2018, the IRS issued Notice 2018-54 and left taxpayers with uncertainty regarding how the utilization of these state tax credits should be reported on the federal income tax return.

New Federal Limit on Deduction of State and Local Taxes

Starting in 2018, an individual's itemized deduction for state income and property taxes is limited to a total of $10,000. Taxpayers who pay high property taxes and/or taxpayers with high income may find their state and local tax deduction limited.

New Federal Standard Deduction

In 2018, the standard deduction for individuals approximately doubles from 2017 amounts. Single taxpayers have a $12,000 standard deduction in 2018 while married couples filing jointly receive a $24,000 standard deduction. The estimated impact of the new standard deduction is to reduce the number of returns in which individuals itemize deductions from 36 million to 16 million.

Impact of New Federal Tax Laws

While fewer individuals will itemize deductions, those who do itemize may be impacted by the new $10,000 limit on the deduction for state and local taxes. These taxpayers may search for options that allow retention of some or all of the tax benefits from the payment of state and local taxes. One option is to make charitable contributions where the contribution entitles the donor to a state tax credit. These credits have become more common across the states and are used to encourage private donations to a variety of activities including private school tuition scholarship programs, shelters for domestic violence, financial aid for college-bound children from low income households, rural hospitals, and many other state-supported programs. Other options include various statutory credits, such as low-income housing credits, or transferable credits purchased at a discount, such as film credits.

Georgia specifically offers a variety of tax credits, including credits for contributions to rural hospitals, private schools, film tax credits, and low-income housing tax credits. Donations to the rural hospital and private education tax credit programs are intended to provide a state income tax credit as well as a federal charitable contribution deduction for those who itemize. As a result, absent any future action taken by the IRS or Congress, donors have the opportunity to exchange nondeductible state income tax payments for deductible charitable contributions on their federal tax returns.

Qualified Education Expense Tax Credit

Georgia's Qualified Education Expense Tax Credit was enacted in 2008 to help provide public school students access to schools that best fit their needs. Both individual and corporate taxpayers are offered Georgia income tax credits in exchange for charitable contributions to Student Scholarship Organizations ("SSO").

The annual tax credit has been capped through 2018 at $58 million but will increase to $100 million for 2019 through 2028. Pre-approval of the Georgia Department of Revenue is required and payment of the contribution is due within 60 days after approval. The credit is limited to the lesser of the individual's tax liability or:

- $1,000 for single taxpayers,
- $2,500 for married taxpayers filing a joint return,
- $1,250 for a married taxpayer filing a separate return, or
- $10,000 for individuals who are members of a limited liability company, shareholders of Subchapter S corporations, or partners in a partnership.

Corporations and fiduciaries are allowed a credit not to exceed the lesser of the actual amount expended or 75 percent of the corporation's or fiduciary's Georgia income tax liability for the tax year.

Applications received have historically exceeded the established cap by the first day of the calendar year. Taxpayers may now make reservations for 2019 credits which will be allocated on January 2, 2019. Some popular SSO programs include Georgia GOAL Scholarship Program (https://goalscholarship.org/), Apogee Scholarship Fund (https://apogee123.org/), and Grace Scholars (https://www.gracescholars.org/).

Georgia Rural Hospital Tax Credit

While the education expense credit has already reached the cap for 2018, the Georgia Rural Hospital Tax Credit program remains available for 2018. It provides Georgia income tax credits to individual and corporate taxpayers for contributions to qualified rural hospital organizations ("RHO") in Georgia. The State of Georgia provides for a total of $60 million of RHO tax credits each year.

Limits on RHO Contributions

When the rural hospital tax credit program began in 2017, Georgia offered a tax credit equal to 90% of the donated amount, up to a maximum credit of $5,000 for single filers, $10,000 for married filers, and 75% of Georgia income tax for C corporations and trusts. During 2017, taxpayers claimed $9 million of the available $60 million of Georgia rural hospital tax credits.

Effective July 1, 2018, the credit increases to 100% of the amount contributed. In addition, the amount that may be donated becomes unlimited until the statewide cap of $60 million is reached. For a taxpayer donating to an RHO from January 1, 2018, through June 30, 2018, Georgia allows a 100% credit for donations received (up to $11,111 for a married filing joint taxpayer and $5,556 for all other individual taxpayers), provided that the statewide $60 million limit has not been reached. Also, corporations are allowed the 100% credit, subject to the 75% of actual Georgia tax liability limit. As of the date of this release, taxpayers have made reservations for $25 million of 2018 Georgia rural hospital tax credits.

Making a Contribution

A list of the 58 qualified Georgia rural hospitals may be found at https://dch.georgia.gov/rural-hospital-tax-credit. Of these hospitals, 52 participate with the Georgia HEART Hospital Program to process their contributions (https://www.georgiaheart.org/). Pre-approval of the Georgia Department of Revenue is required in order to participate and claim the credit. The taxpayer is required to make the contribution within 60 days after approval.

Tax Benefits from Contributions

Under both programs, an individual, for example, receives a $10,000 Georgia tax credit in exchange for the $10,000 charitable contribution to the program. If the individual itemizes deductions and is in the 37% federal marginal tax rate bracket, the federal tax benefit for the charitable contribution is $3,700 (37% x $10,000). The total tax benefit for a $10,000 contribution is $13,700 ($10,000 Georgia credit plus $3,700 federal tax benefit), which is a net benefit of 37%.

For a individual who does not itemize deductions, the tax benefit equals the Georgia tax credit. An individual who makes a $10,000 donation and receives a $10,000 Georgia tax credit breaks even since the donation amount and the Georgia tax credit are equal.

IRS Notice 2018-54

The U.S. Department of the Treasury and the Internal Revenue Service issued IRS Notice 2018-54 on May 23, 2018, stating that they intend to issue proposed regulations addressing the federal income tax treatment of certain payments made by taxpayers for which taxpayers receive credits against their state and local taxes. The Notice also informs taxpayers that federal law controls the characterization of the payments for federal income tax purposes regardless of the characterization of the payments under state law.

The Notice does not provide any insight as to what position the IRS will take in the matter. Under a narrow approach, the federal government would have to examine each entity receiving a donation that benefited from a state charitable tax credit. A determination would have to be issued as to whether the contributions to the entity either 1) qualify for a full federal deduction even when the donor is reimbursed with a state tax credit or 2) categorize the reimbursed portion of the contribution as a state tax payment subject to the $10,000 cap. Under a broader approach, the federal government would determine when a charitable contribution has been made (i.e., whether the receipt of a state tax credit qualifies as a "benefit received" and therefore renders the contribution not deductible). Under this approach, there would be no need for the IRS to make new distinctions between the different types of organizations currently eligible to receive tax deductible charitable gifts.

Analysis and Planning

It is impossible to predict which direction federal regulations will take in this matter. But given that Georgia limits the size of the hospital tax credit program to $60 million, taxpayers will likely have to decide on their 2018 participation in the program before those regulations are published.

If donations to the rural hospital tax credit program are treated as tax-deductible charitable contributions, the tax benefits from participating in the program are larger than the donation amount. As discussed above, a person in the highest tax bracket and who itemizes on their federal return realizes a 37% benefit while also helping Georgia rural hospitals. A similar result occurs for current and future donations to the Qualified Education tax credit program.

However, if the IRS determines that the donations are not deductible as charitable contributions, a donor is in a break-even position, with the Georgia tax credit equaling the amount donated. There could also be a cost to a taxpayer who has already filed a tax return reporting the donation if the determination is retroactive to all open years. In this situation, the taxpayer would need to amend their return to remove the charitable contribution, and remit the federal tax, penalty, and interest due.

Additional Options to Consider

If a donor wants more certainty, he or she could choose to participate in another tax credit program such as purchasing of Georgia film credits. The State of Georgia offers tax credits to companies producing television shows, movies, videos, and similar media in Georgia. If these producers cannot use their film tax credits, they are permitted to sell them to other taxpayers. We have seen recent market average prices for film credits around $0.905 per dollar of credit. A purchaser must report the discount (9.5% in this example) as a short or long-term capital gain, depending on whether the taxpayer holds the film credits for one year before filing a return using the credits. As an example, if a taxpayer buys $1,000 of film credits for $.905 on the dollar, the taxpayer reports $95 as a short-term capital gain. If the taxpayer is in the highest tax brackets of 37% for federal and 6% for Georgia, $41 of tax is due on the capital gain. The net benefit is $54 ($95 for the film credit less $41 of tax), which is a 5.4% rate of return.

As we await the release of the federal regulations, taxpayers are facing an uncertain choice of rural hospital tax credits and qualified education tax credits with a rate of return that could range from slightly negative to 37% positive, compared to a more certain 5.4% return on film credits. Taxpayers should discuss with a tax advisor which options or combinations of tax credits are best suited for their needs.

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