

**Bruce P. Ely**  
bely@bradley.com  
205.521.8366 direct



October 9, 2018

Hon. Charles P. Rettig  
Commissioner of Revenue  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20224

CC:PA:LPD:PR (REG-112176-18)  
Room 5203  
Internal Revenue Service  
P.O. Box 7604  
Ben Franklin Station  
Washington, DC 20044

Re: Comments on Proposed Regulations Under IRC Section 170 (REG-112176-18)

Dear Commissioner Rettig:

Congratulations on your appointment as Commissioner of Revenue. Enclosed are comments for the record on the proposed regulations published in the Federal Register on August 27, 2018 under IRC Section 170, addressing the availability of a charitable contribution deduction when a taxpayer receives or expects to receive a corresponding state or local tax credit ("Comments"). These Comments are submitted on behalf of our client, the Alabama Opportunity Scholarship Fund, a private, nonprofit scholarship-granting organization based in the State of Alabama.

I would be pleased to discuss the Comments with you or your staff if that would be helpful.

Respectfully submitted,

A handwritten signature in cursive script that reads "Bruce Ely".

Bruce P. Ely

Enclosure

cc: Ms. Lesley Searcy, Executive Director, Alabama Opportunity Scholarship Fund

**COMMENTS ON PROPOSED REG. §§ 1.170A-1 and -13  
BY THE ALABAMA OPPORTUNITY SCHOLARSHIP FUND**

Dear Commissioner Rettig:

I am writing on behalf of our client, the Alabama Opportunity Scholarship Fund (“AOSF”), an Alabama-based private nonprofit scholarship-granting organization. These Comments are intended to supplement the excellent comment letter submitted by the American Federation for Children (the “AFC Letter”) on or about October 9, 2018.

AOSF was established in 2013 to provide K-12 educational scholarships to low-income children across the state of Alabama. AOSF receives donations from individual and business donors to enable it to offer these scholarships, with priority given to students who are zoned to attend “failing” public schools. A minimum of 95% of these donations must be used to fund scholarships, according to state law. These scholarships enable students to attend the better-performing public or private school of their choice, through a parent-driven model that seeks to provide all children in our state with an equal opportunity to receive a quality education. See [www.alabamascholarshipfund.org](http://www.alabamascholarshipfund.org).

AOSF currently provides scholarships to over 1,600 low-income children (82% of whom are minorities), with approximately 20,000 more children on their waiting list. There are other, similarly-situated SGOs in our state that, together with our students, fund scholarships for almost 4,000 low-income children. There are 22 similar organizations operating in 17 other states, often called scholarship funding organizations or student tuition organizations. See *Arizona Christian School Tuition Org. v. Winn*, 563 U.S. 125 (2011). For purposes of this comment letter we will employ the acronym “SGO” to mean and include all these organizations. These organizations, collectively, provide educational scholarships for over 291,000 low income children.

We write to express our deep concerns regarding the overly broad scope of the proposed regulations under IRC Section 170 (REG-112176-18) published in the Federal Register on August 27, 2018 (the “Proposed Regulations”). We understand the concern that certain states and some local governments have established or propose to establish state- or local government-run organizations in an attempt to minimize or bypass the new limitation on the deduction for state and local taxes under Section 164(b)(6). However, the Proposed Regulations cast far too wide a net by also punishing the beneficiaries of independent, private SGOs that were established well before December 22, 2017, the date of enactment of the legislation commonly known as the Tax Cuts and Jobs Act of 2017, P.L. No. 115-97 (the “Act”), and without regard to the new SALT deduction limitations. While our donors are primarily motivated by a desire to provide scholarships to Alabama K-12 students in need, the income tax credits offered by the State of Alabama and the longstanding federal income tax deduction under Section 170 incentivize these donors to contribute more than they would without such financial incentives.

The Proposed Regulations, if finalized in their current form, will simply cause certain state legislatures and local governments to find alternative methods to undermine the SALT cap, and will keep the validity and implementation date of the Proposed Regulations in limbo by constant litigation. In the meantime, thousands of children, parents/guardians, schools, and communities

that rely on independent SGOs, not only in Alabama but in 17 other states, will be left behind. AOSF and other SGOs operating in Alabama expect to see a substantial decrease in donations next year if the Proposed Regulations are implemented in their current form, or are held in limbo, and thus will be forced to cancel existing scholarship commitments as well as substantially reduce the number of scholarships granted in the future, despite the long waiting list.

We suggest the following proposals, which will accomplish the stated goal of denying charitable contribution deductions for contributions to state- or local government-run organizations while minimizing the collateral damage to truly independent SGOs and their student-beneficiaries:

**1. Revise the Proposed Regulations to carve-out private, non-profit SGOs that operate independently of state or local government control.**

The Proposed Regulations should be revised to narrowly address the organizations truly at issue, i.e., state-established and run or in some cases local government-run organizations that were formed primarily to allow their resident taxpayers to avoid the SALT cap and not primarily to further an educational policy objective. These government-created and -run organizations are clearly distinguishable from independent, private nonprofit organizations that operate without state funding and direct control; and as such, the Proposed Regulations should be revised to exclude payments made to organizations organized and operated exclusively for educational purposes in accordance with Section 170(c)(2). This would distinguish organizations that exist solely for educational purposes from organizations that operate as an extension of a state or a local government. By carving out these independent educational organizations, the Proposed Regulations would achieve the desired effect of discouraging the creation of government-run organizations to undermine the new Section 164(b)(6) limitations, while preserving the previously-approved and longstanding tax incentives granted to individuals and businesses who choose to support socially-beneficial SGOs in Alabama and across the United States.

A similar result may be accomplished by limiting the scope of the final regulations to donations made to state governments and political subdivisions exempt from income tax under Section 170(c)(1). This recommendation is described in more detail in the AFC Letter, and AOSF fully supports the recommendation contained therein.

**2. Adopt a “facts-and-circumstances” test to determine whether a scholarship-granting organization operates independently of the state or local government.**

If the Treasury Department is not inclined to limit the scope of the Proposed Regulations to the state or local government entities that are the crux of the issue, the Proposed Regulations should be revised to create a “facts-and-circumstances” test to determine whether a particular SGO operates independently of a state or local government. Potential factors for this test are outlined in the well-reasoned comment letter submitted by James P. Kelly, III dated September 13, submitted on behalf of the Georgia GOAL Scholarship Program and echoed in a comment letter from U.S. Senator John Isakson of the State of Georgia. AOSF agrees that this type of test would allow the IRS to distinguish between contributions to state- or local government-run organizations that seek to undermine the SALT cap limitations vs. to private, independent SGOs designed to

further education policies and school choice. If such a facts-and-circumstances test is adopted, however, the IRS should also make clear that it will offer private letter rulings to qualified SGOs in order to provide donors with certainty regarding the federal income tax treatment of their contributions.

**3. Create a “grandfather rule” to distinguish private, independent SGOs in existence prior to the passage of the Act.**

In the alternative, the Proposed Regulations should be revised to exclude contributions to SGOs established prior to December 22, 2017. Clearly, the state- or local government-run organizations at issue were established or will be established in response to the new Section 164(b)(6) limitations in the Act. By limiting the application of the Proposed Regulations to organizations that were established after the passage of the Act, the regulations would prohibit deductions for organizations formed as a result of the Act while continuing to allow deductions for donations to SGOs whose existence is completely independent of any provisions of the Act.

**4. Provide clarification regarding deductions for contributions made by pass-through entities to SGOs.**

If the Treasury Department is unwilling to provide general relief for independent SGOs, the IRS should at least provide clarity regarding the availability of deductions under Sections 162 and 164 for contributions to SGOs such as AOSF by entities classified by the Service as partnerships, S corporation, sole proprietorships, or certain disregarded entities (collectively, “pass-through entities”). News Release IR-2018-178 (Sept. 5, 2018) and Secretary Mnuchin’s public statements provided some reassurance that the Proposed Regulations are not intended to affect the federal income tax treatment of donations by “business taxpayers” to SGOs “as long as the payment qualifies as an ordinary and necessary business expense.” Deductions to SGOs by C corporations therefore seem to have been automatically approved. However, many questions remain regarding the proper treatment of payments to SGOs by thousands of pass-through entities.

In particular, pass-through entity donors engaged in a trade or business remain concerned that the IRS will challenge the deductibility of their contributions to SGOs as not constituting “ordinary and necessary” business expenses, the deduction for which passes-through to the entity’s owner(s). Since donations by “business taxpayers” (the phrase used in the News Release and accompanying FAQ) are not affected by the SALT deduction limitation, it seems that the Proposed Regulations are not intended to affect these donors. *See, e.g.,* Revenue Ruling 81-288 (confirming that the payment of a “business profits tax” by a pass-through entity was deductible by the owner). To provide clarity regarding the federal income tax treatment of donations by these business entities, the Proposed Regulations should be amended to expressly state that donations made by these businesses to SGOs continue to qualify as “ordinary and necessary” business expenses for purpose of Section 162, or as the payment of a state or local tax under Section 164 (by use of the state tax credit granted as a result of the donation), as appropriate.

Previous cases show that a contribution to a charitable organization by a pass-through entity may be eligible for a Section 162 deduction if the business expects to receive some financial

benefit or value in return for the contribution. *See, e.g., Dunnegan v. Comm'r*, T.C. Memo. 2002-119 (2002). Potential donors to SGOs are uncertain as to the treatment of contributions for which the donor receives a state tax credit as well as intangible value related to the taxpayer's business. For example, the local playground equipment manufacturer [classified as a pass-through entity] donates funds to a qualified SGO in an effort to improve the educational qualifications of its future workforce and to generate goodwill among its employees and customers. That donation should continue to qualify under Section 162, or under Section 164 in cases where the pass-through entity is a disregarded entity (e.g., a single member LLC) or a sole proprietorship that will offset the state tax credit against its owner's personal state or local tax obligations.

#### **5. Create an Exception for Taxpayers Falling Below the Section 164(b)(6) Threshold**

SGOs receive contributions from individual donors whose annual state and local tax liabilities fall below the new \$10,000 limitation in Section 164(b)(6). For these donors, the Proposed Regulations would prohibit entirely the deduction for contributions under Section 170 despite the fact that payments of additional state income tax would be deductible by the donor under Section 164. As discussed in more detail in the helpful comment letter by the Council on Foundations dated September 27, 2018, the final regulations should contain an exception for contributions by such individual donors if (or to the extent) a deduction under Section 164 for the corresponding state income tax would not be limited by Section 164(b)(6).

#### **6. Delay the effective date of the Proposed Regulations.**

Finally, if you are unwilling to move forward with any of the above options, at the very least the effective date of the Proposed Regulations should be delayed. We note the many other comment letters requesting the same limited relief. Donors to AOSF and other SGOs have expressed concern regarding the deductibility under Section 170 of their donations previously made or to be made pursuant to a previous written pledge, during 2018 calendar year. Many of these donations were made or pledged to be made well in advance of the publication of the Proposed Regulations. At a minimum and to provide clarity for these donors, the Proposed Regulations should not become effective until calendar year 2019.

\* \* \* \*

Thank you in advance for your favorable consideration. If you have any questions or wish to discuss these requests, please contact either the principal author of this comment letter at the letterhead address or Ms. Lesley Searcy at AOSF, [lsearcy@alabamascholarshipfund.org](mailto:lsearcy@alabamascholarshipfund.org).

Bruce P. Ely  
Bradley Arant Boult Cummings LLP  
One Federal Place  
1819 Fifth Avenue North  
Birmingham, Alabama 35203  
(205) 521-8366  
[bely@bradley.com](mailto:bely@bradley.com)