Review of the Issuance Process for Notice 2018-54

February 22, 2019

Reference Number: 2019-14-019

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:
7 = Information Reflecting the Bureau's Decisionmaking Process

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HIGHLIGHTS

REVIEW OF THE ISSUANCE PROCESS FOR NOTICE 2018-54

Highlights

Final Report issued on February 22, 2019

Highlights of Reference Number: 2019-14-019 to the Commissioner of Internal Revenue.

IMPACT ON TAXPAYERS

On December 22, 2017, the President signed Public Law 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA). The TCJA made significant changes to the tax code affecting individuals, businesses, and tax-exempt organizations. One such change limits individual taxpayer deductions for State and local taxes to $10,000 a year ($5,000 a year for married filing separate taxpayers). TIGTA estimates that this change could affect more than 10 million taxpayers in Tax Year 2018.

WHY TIGTA DID THE AUDIT

TIGTA initiated this audit based on a request from the Chairman of the U.S. House of Representatives Committee on Ways and Means concerning the prioritization and issuance of IRS Notice 2018-54, *Guidance on Certain Payments Made in Exchange for State and Local Tax Credits*. The overall objective of this audit was to evaluate the process used to prioritize and issue IRS Notice 2018-54.

WHAT TIGTA FOUND

TIGTA determined ************7*************** ******************************7********************* ******************************7*********************** ******************************7************************* ****************7***************. In addition, TIGTA found that ****************7*********************** *****************************7******************** *****************************7********************* **7**.

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****************************7*********************** ****************************7*********************** ****************************7*********************** ****************************7*********************** ****************************7*********************** ****************************7*********************** ****************************7*********************** ****************************7*********************** *************7************. Given the potential impact on millions of taxpayers, TIGTA found the review and approval process for Notice 2018-54 to be reasonable.

WHAT TIGTA RECOMMENDED

TIGTA made no recommendations as a result of the work performed during this review.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

February 22, 2019

MEMORANDUM FOR COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Review of the Issuance Process for Notice 2018-54 (Audit # 201810024)

This report presents the results of our review to assess the process used to *****7**** issue Internal Revenue Service (IRS) Notice 2018-54, *Guidance on Certain Payments Made in Exchange for State and Local Tax Credits*. This audit was requested by the Chairman of the U.S. House of Representatives Committee on Ways and Means. This audit is included in our Fiscal Year 2019 Annual Audit Plan and addresses the major management challenge of Implementing the Tax Cuts and Jobs Act and Other Tax Law Changes.

Copies of this report are also being sent to the IRS managers affected by the report finding. If you have any questions, please contact me or Deann L. Baiza, Acting Assistant Inspector General for Audit (Management Services and Exempt Organizations).

Table of Contents

Abbreviations

IRS	Internal Revenue Service
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SALT	State and Local Tax
TCJA	Tax Cuts and Jobs Act

Background

On December 22, 2017, the President signed Public Law 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA).[1] The TCJA made significant changes to the tax code affecting individuals, businesses, and tax-exempt organizations. Most changes in the new law take effect in Calendar Year[2] 2018 and will affect tax returns filed in Calendar Year 2019.

One of the TCJA provisions limits individual taxpayer deductions for State and local tax (SALT) payments to $10,000 a year ($5,000 for a married person filing a separate return), beginning in Tax Year[3] 2018 and expiring at the end of Calendar Year 2025. SALT payments (including income and real property taxes) that exceed those amounts are no longer deductible by individual taxpayers unless the payments are made in pursuit of a trade or business.[4] This also will affect taxpayers who must choose between taking the standard deduction[5] or itemizing their deductions on Form 1040, *U.S. Individual Income Tax Return*, Schedule A, *Itemized Deductions*. When the TCJA became law, the standard deduction amounts increased as shown in Figure 1:

Figure 1: Standard Deduction Amounts and SALT Deduction Limitations Before and After the Passage of the TCJA

Filing Status	Tax Year 2017 Standard Deduction	Tax Year 2018 Standard Deduction	Tax Year 2018 SALT Limitation Amount
Single	$ 6,350	$ 12,000	$ 10,000
Married Filing Jointly	$ 12,700	$ 24,000	$ 10,000
Married Filing Separately	$ 6,350	$ 12,000	$ 5,000
Head of Household	$ 9,350	$ 18,000	$ 10,000

Source: IRS Publication 5307, Tax Reform Basics for Individuals and Families (October 2018) and Publication 17, Your Income Tax for Individuals (2017).

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[1] Pub. L. No. 115-97 (2017).
[2] The 12-consecutive-month period ending on December 31.
[3] A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
[4] Before the TCJA became law, there was generally no limitation on the amount of SALT payments that taxpayers could deduct assuming the tax was assessed by the taxing authority and paid by the taxpayer.
[5] The standard deduction is a dollar amount that reduces the amount of income on which you are taxed and varies according to your filing status; taxpayers cannot take the standard deduction if they itemize deductions on Schedule A. The standard deduction is higher if a taxpayer is blind or over age 65.

To determine the impact of the new cap on SALT deductions, we reviewed Federal tax returns filed in Tax Year 2017 and estimate that, if the SALT limitation had been in place in Tax Year 2017, it would have affected approximately 10.9 million taxpayers who would have been unable to deduct approximately $323 billion in SALT payments on Form 1040 Schedule A. See Figure 2 for more information.

Figure 2: Estimated Number of Taxpayers Subject to the SALT Limitations, and Amounts of State and Local Taxes Paid Over the SALT Limitations in Tax Year 2018[6]

Filing Status	Number of Taxpayers[7]	Total Amount Over SALT Limitation
Single	2,151,826	$ 116,744,057,916
Married Filing Jointly	7,763,869	$ 185,864,115,484
Married Filing Separately	391,820	$ 5,772,842,933
Head of Household	573,055	$ 14,746,499,306
TOTALS	**10,880,570**[8]	**$ 323,127,515,639**[9]

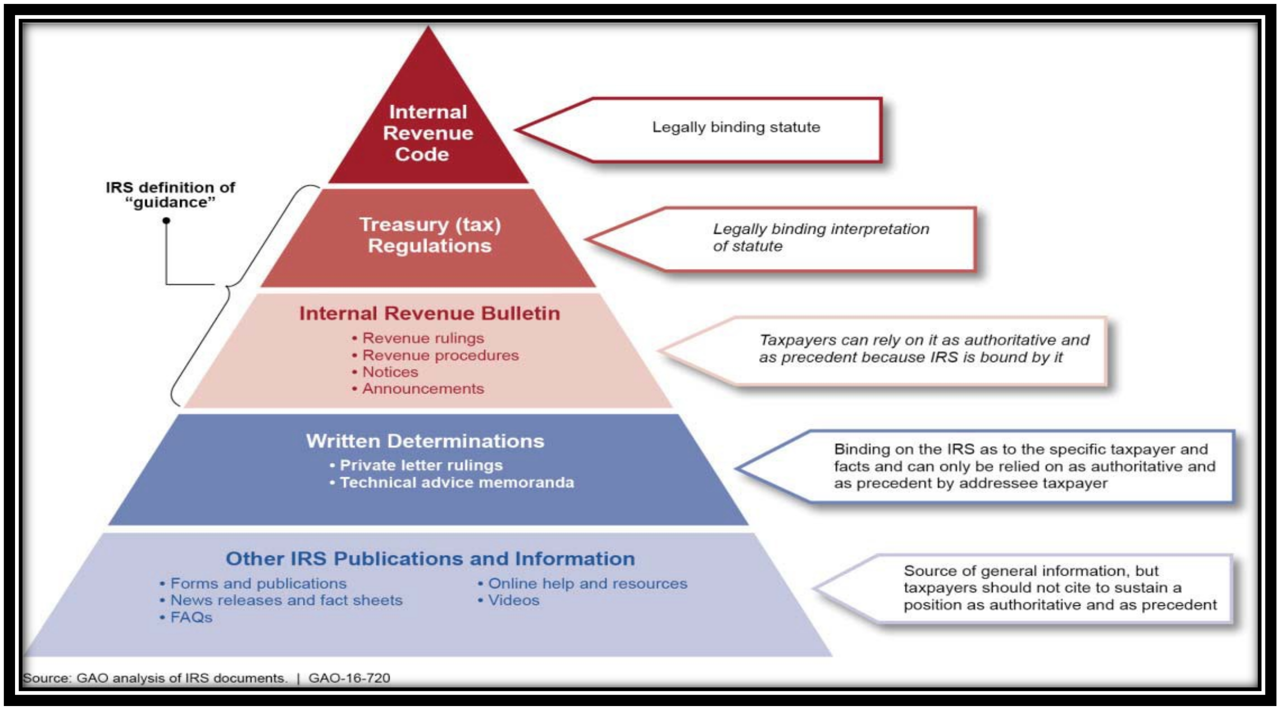
Source: Treasury Inspector General for Tax Administration calculations based on tax returns filed in Tax Year 2017.

Whenever Congress enacts new legislation affecting the tax code,[10] the Internal Revenue Service (IRS) Office of Chief Counsel (hereafter referred to as Chief Counsel) is responsible for determining if guidance is necessary to address the new legislation. Chief Counsel also develops tax-related guidance for the public through its Priority Guidance Plan. While developing the annual Priority Guidance Plan, the IRS and the Department of the Treasury (hereafter referred to as Treasury) solicit recommendations from the public for items to include in the Plan. The type of guidance the IRS issues ranges from publishing informal news or press releases up to issuance of regulations, which are the most authoritative type of guidance.[11] Regulations provide

[6] The estimate is based upon taxpayers claiming the same amount of deductions on Schedule A in Tax Year 2018 as they claimed in Tax Year 2017 and is designed to measure potential impact of the new SALT limitations and standard deduction increases per filing status.
[7] Based on Tax Year 2017 filings in which the Schedule A amounts exceed the Tax Year 2018 standard deduction.
[8] We estimated the number of taxpayers that may be subject to the SALT limitations (for Tax Year 2018) by identifying Schedule A returns that claimed more than $10,000 in real estate, State, and local taxes paid in Tax Year 2017.
[9] We calculated the cumulative amount of real estate, State, and local taxes that exceeded the $10,000 SALT limitation ($5,000 for married filing separately) for each Schedule A tax return filed in Tax Year 2017 to estimate the Tax Year 2018 amount in excess of the SALT limitation.
[10] Federal tax law begins with the Internal Revenue Code, enacted by Congress in Title 26 of the United States Code.
[11] Regulations are published in both the Internal Revenue Bulletin and the Federal Register.

Treasury's and IRS's official interpretation of tax laws and are binding on taxpayers because they have the force and effect of law.[12] Figure 3 illustrates the hierarchy of authority for IRS guidance.

Figure 3: Hierarchy of Authority for IRS Guidance and Other Information Sources



Source: Government Accountability Office analysis of IRS documents in a September 2016 report.[13]

Published guidance is important because it helps IRS personnel apply the tax laws correctly and uniformly and assists taxpayers with voluntarily complying with the tax laws. In addition, the IRS publishes guidance in the Internal Revenue Bulletin, which is the authoritative instrument for publishing revenue rulings, revenue procedures, notices, and announcements. *****7***** ********************************7*****************************

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[12] Generally, regulations are first published in proposed form in a Notice of Proposed Rulemaking. After public input is fully considered through written comments and even a public hearing, a final regulation or a temporary regulation is published as a Treasury Decision in the Federal Register.
[13] Government Accountability Office, GAO 16-720, *Regulatory Guidance Processes: Treasury and OMB Need to Reevaluate Long-standing Exemptions of Tax Regulations and Guidance* (Sept. 2016). OMB is the Office of Management and Budget.

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In addition, Chief Counsel, as the chief legal advisor to the IRS Commissioner on all matters pertaining to the interpretation, administration, and enforcement of the Internal Revenue Laws (as well as all other legal matters), provides legal guidance and interpretive advice to the IRS, Treasury, and to taxpayers.

This review was performed at the IRS National Headquarters in Washington, D.C., ****7***** ******7****** during the period June through November 2018. This review was requested by the Chairman of the U.S. House of Representatives Committee on Ways and Means. Based on the request, the scope of this audit was limited to the process followed by the IRS to ****7**** *7* issue Notice 2018-54, and who was involved in the process. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Results of Review

The Internal Revenue Service ***************7******************Issued Notice 2018-54

We determined that ************************7********************************* **7********************************** **7********************************** **********************7********************** This guidance was initially released in the form of Notice[14] 2018-54, *Guidance on Certain Payments Made in Exchange for State and Local Tax Credits*, and later in the form of draft regulations. *************7************ **7********************************** **7********************************** **7********************************** **7*********************[15] ******** *******************[16] ******************7************************ the IRS issued it to the public on May 23, 2018, via an IRS News Release, IR-2018-122.

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[14] A notice is a public pronouncement by the IRS that may contain guidance that involves substantive interpretations of the Internal Revenue Code or other provisions of the law.

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*******************************7*********************** approved it for issuance. On May 23, 2018, the IRS released Notice 2018-54 to the public. As shown in Figure 4, it was the 24th guidance item issued concerning the TCJA since the law's enactment.

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Figure 4: Number of TCJA Guidance Items Issued Before Notice 2018-54

Type of TCJA Guidance	Number of Guidance Items
Proposed or Final Regulations	None
Revenue Rulings	1
Revenue Procedures	7
Notices	14
Frequently Asked Questions	1
Total Guidance Issued by May 22, 2018	**23**

Source: Office of Chief Counsel, July 2018. Note: Notice 2018-54 was issued to the public on May 23, 2018, via an IRS News Release, IR-2018-122.

Notice 2018-54 stated that Treasury and the IRS intend to propose regulations addressing the Federal income tax treatment of certain payments for which taxpayers receive a credit against their State and local taxes. The Notice 2018-54 also informed the public "the proposed regulations [would] assist taxpayers in understanding the relationship between the Federal charitable contribution deduction and the new statutory limitation on the deduction for State and local tax payments."

On August 23, 2018, Chief Counsel released proposed regulations addressing contributions in exchange for State and local tax credits associated with the SALT limitations. Chief Counsel advised us that the IRS would allow the public 45 days for submitting comments[21] ****7*****
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The proposed regulations generally provide that "if a taxpayer makes a payment or transfers property to or for the use of an entity listed in section 170(c), and the taxpayer receives or expects to receive a State or local tax credit in return for such payment, the tax credit constitutes a return benefit, or quid pro quo, to the taxpayer and reduces the charitable contribution deduction."[22] **************************7*********************.

[21] Internal Revenue Manual 32.1.2.3 (4) a (08-16-2018) states that "the public should generally be afforded a period of at least 60 days to comment on the proposed regulation." The IRS has stated that the public comment period typically ranges from 30 to 90 days.
[22] Proposed REG-112176-18, dated August 23, 2018. We did not audit the process followed to issue the proposed regulations as part of this audit because they were not final at the time of this report. The scheduled public hearing was held on November 5, 2018.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective was to evaluate the process used to *****7***** issue IRS Notice 2018-54, *Guidance on Certain Payments Made in Exchange for State and Local Tax Credits*. To accomplish our objective, we:

I. Obtained and reviewed guidance applicable to issuance of IRS notices and other guidance.

   A. Determined how the IRS ***************7*********************.

   B. Determined individuals responsible for issuing IRS notices and other guidance.

   C. Determined the number of taxpayers potentially affected by the new legislation provision related to State and local tax deductibility.

II. Interviewed staff involved in the issuance of Notice 2018-54, obtained supporting documentation, and gained an understanding of:

   A. The chronology for issuance of Notice 2018-54.

   B. The factors involved in deciding to issue Notice 2018-54.

   C. The staffing involved in the issuance of Notice 2018-54.

   E. ********************************7******************************* ********************************7****************************

   F. The status of final regulatory guidance.

III. Determined whether the IRS followed its established policies and procedures for issuance of Notice 2018-54.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: *****7******policies and prioritization for issuing notices. We evaluated these controls by reviewing ******7****** guidance, interviewing ***************7******************* personnel, evaluating the documentation related to Notice 2018-54, and analyzing the review process for Notice 2018-54.

Appendix II

Major Contributors to This Report

Deann L. Baiza, Acting Assistant Inspector General for Audit (Management Services and Exempt Organizations)
Troy D. Paterson, Director
Jonathan T. Meyer, Director
Janice M. Pryor, Audit Manager
Yasmin B. Ryan, Lead Auditor
Mary F. Herberger, Senior Auditor
Thomas F. Polsfoot, Senior Auditor
Joseph P. Smith, Senior Auditor

Appendix III

Report Distribution List

Deputy Commissioner – Attn: Chief of Staff
Chief Counsel
Director, Office of Audit Coordination

Appendix IV

Notice 2018-54

Guidance on Certain Payments Made in Exchange for State and Local Tax Credits

NOTICE 2018-54

SECTION 1. PURPOSE

This notice informs taxpayers that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to propose regulations addressing the federal income tax treatment of certain payments made by taxpayers for which taxpayers receive a credit against their state and local taxes.

SECTION 2. BACKGROUND

Section 11042 of "The Tax Cuts and Jobs Act," Pub. L. No. 115-97, limits an individual's deduction under § 164 for the aggregate amount of state and local taxes paid during the calendar year to $10,000 ($5,000 in the case of a married individual filing a separate return). State and local tax payments in excess of those amounts are not deductible. This new limitation applies to taxable years beginning after December 31, 2017, and before January 1, 2026.

In response to this new limitation, some state legislatures are considering or have adopted legislative proposals that would allow taxpayers to make transfers to funds controlled by state or local governments, or other transferees specified by the state, in exchange for credits against the state or local taxes that the taxpayer is required to pay. The aim of these proposals is to allow taxpayers to characterize such transfers as fully deductible charitable contributions for federal income tax purposes, while using the same transfers to satisfy state or local tax liabilities.

Despite these state efforts to circumvent the new statutory limitation on state and local tax deductions, taxpayers should be mindful that federal law controls the proper characterization of payments for federal income tax purposes.

SECTION 3. GUIDANCE TO BE ISSUED

The Treasury Department and the IRS intend to propose regulations addressing the federal income tax treatment of transfers to funds controlled by state and local governments (or other state-specified transferees) that the transferor can treat in whole or in part as satisfying state and local tax obligations. The proposed regulations will make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers. The proposed regulations will assist taxpayers in understanding the relationship between the federal charitable contribution deduction and the new statutory limitation on the deduction for state and local tax payments.

SECTION 4. DRAFTING INFORMATION

The principal authors of this notice are Mon Lam and Merrill Feldstein of the Office of Associate Chief Counsel (Income Tax & Accounting). Other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, contact Ms. Lam or Ms. Feldstein at (202) 317-5100 (not a toll-free call).

Appendix V

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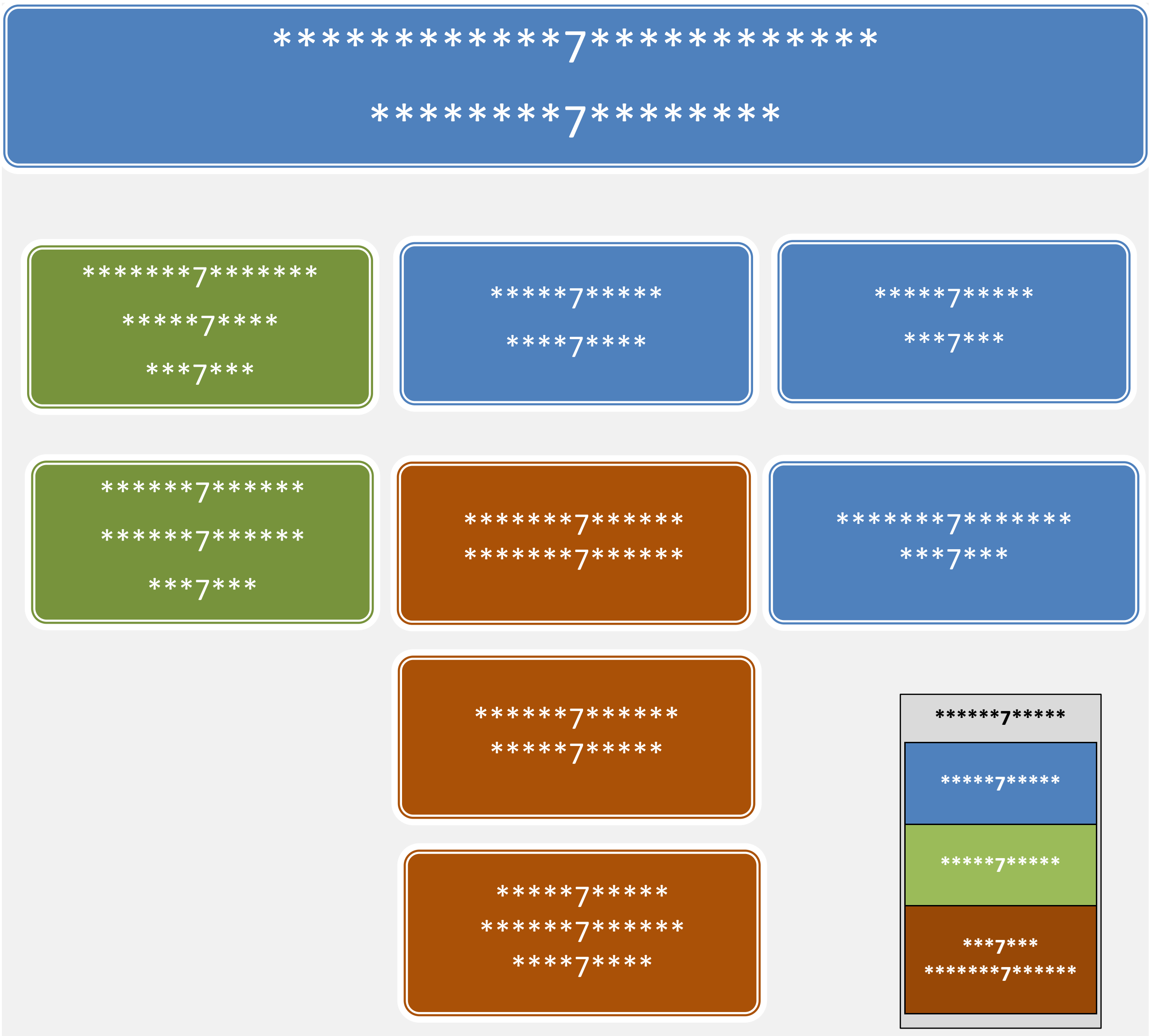

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Appendix VI

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Appendix VII

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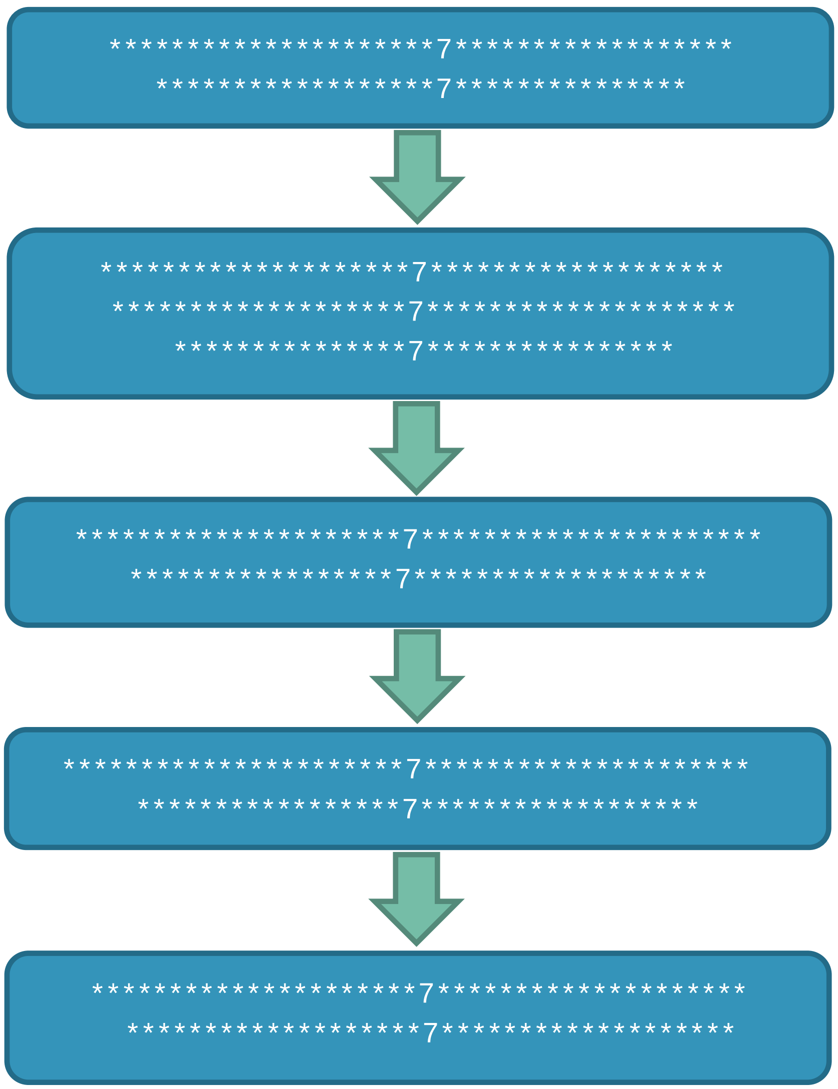

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Appendix VIII

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