**UNITED STATES DISTRICT COURT**
**FOR THE SOUTHERN DISTRICT OF NEW YORK**

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| VILLAGE OF SCARSDALE, NEW YORK,<br><br>Plaintiff,<br>v.<br><br>INTERNAL REVENUE SERVICE; CHARLES P. RETTIG, in his official capacity as Commissioner of Internal Revenue; UNITED STATES DEPARTMENT OF THE TREASURY; and STEVEN T. MNUCHIN, in his official capacity as Secretary of the Treasury,<br><br>Defendants. | Civil Action No.: 7:19-cv-6654<br><br>**COMPLAINT FOR DECLARATORY AND INJUNCTIVE RELIEF** |

## INTRODUCTION

The Village of Scarsdale, New York, files this Complaint seeking declaratory and injunctive relief against the Internal Revenue Service; Charles P. Rettig, in his official capacity as Commissioner of Internal Revenue; The United States Department of the Treasury; and Steven T. Mnuchin, in his official capacity as Secretary of the Treasury (collectively, "Defendants") and, in support thereof, states the following:

1. On June 13, 2019, Defendants issued final regulations purposefully designed to frustrate otherwise deductible contributions to state and municipal charitable funds "when a taxpayer receives or expects to receive a corresponding state or local tax credit" (the "Final Regulations"). *See Contributions in Exchange for State and Local Tax Credits*, 84 Fed. Reg. 27513, 27513 (Jun. 13, 2019) (codified at 26 C.F.R. § 1.170A-1 and -13).

2. The Final Regulations usurp the lawmaking function and purport to unilaterally impose the current administration's political will in violation of clear statutory limits. If the Final Regulations are allowed to stand, state and municipal charitable funds nationwide, including Scarsdale's charitable gifts reserve fund, will continue to suffer irreparable harm caused by the Defendants' unauthorized and unlawful actions.

3. Under the Code,[1] while a state or local tax credit reduces the amount of a taxpayer's state or local tax liability, it is *not* a separate item of consideration, like an item of property. Judicial precedents, published guidance binding on the Defendants, and IRS administrative pronouncements all reinforce this basic and longstanding principle.

4. The Final Regulations purport to override this basic and longstanding principle by treating state and local tax credits as separate items of consideration solely for purposes of determining the amount of a taxpayer's federal charitable contribution deduction.

5. In 2017, Congress amended one part of the Code to limit an individual's deduction for the aggregate amount of state and local taxes paid during the calendar year to $10,000, or $5,000 in the case of a married individual filing a separate return. Section 164(b)(6). Congress also made certain changes to the deduction for charitable contributions under Section 170 (*e.g.*, increasing the percentage of a taxpayer's income that is deductible under Section 170 for cash donations and preventing taxpayers from deducting donations for college athletic event seating rights). *See* Pub. L. No. 115-97, §§ 11023, 13704; H.R. Rep. 115-466 (Conference Report), at 273), which are inconsequential to this present action.

[1] All "Code" and "Section" references are to the Internal Revenue Code of 1986 (Title 26 of the United States Code), as amended.

6. The 2017 amendments to Section 164 and Section 170 provide no legal basis to issue final rules regarding the deductibility of contributions to state and municipal charitable funds, such as those set forth in the Final Regulations.

7. The Final Regulations arbitrarily and capriciously treat state and local tax credits as having value *solely* for purposes of Section 170 charitable contribution deductions, treating otherwise identically-situated tax situations and taxpayers differently without a congressional mandate or any other rationale for doing so.

8. Furthermore, the safe harbors and carve outs contained in the Final Regulations and linked sub-regulatory guidance issued by Defendants arbitrarily and capriciously lead to results at odds with the stated goal of applying the Final Regulations to substantial state or local tax benefits, and result in divergent consequences for substantively identical circumstances without any statutory authority, let alone a reasoned explanation, for doing so.

9. Accordingly, and to protect its charitable gifts reserve fund from the Defendants' unlawful actions, Scarsdale requests that this Court grant declaratory and injunctive relief, setting aside the Final Regulations and enjoining their implementation.

## JURISDICTION AND VENUE

10. This action arises under the Administrative Procedure Act (the "APA"), 5 U.S.C. §§ 553, 701–706.

11. This Court has subject-matter jurisdiction pursuant to 28 U.S.C. § 1331 and the APA, 5 U.S.C. § 702.

12. Venue is proper in this district pursuant to 28 U.S.C. § 1391(e).

**THE PARTIES**

13. Scarsdale is a municipal corporation organized pursuant to New York law.

14. Defendant Department of the Treasury ("Treasury") is an executive department of the United States of America responsible for the promulgation of rules and regulations under the Code, including the Final Regulations. 26 U.S.C. § 7801; 31 U.S.C. § 301. Treasury is an "agency" as that term is defined by 5 U.S.C. § 701(b)(1).

15. Defendant Stephen T. Mnuchin ("Mnuchin") is the Secretary of the Treasury and is responsible for overseeing the Department of the Treasury and the Internal Revenue Service. *See* 26 U.S.C. § 7801. The claims against Defendant Mnuchin are asserted against him in his official capacity as the Secretary of the Treasury.

16. Defendant Internal Revenue Service ("IRS") "is a bureau of the Department of the Treasury under the immediate direction of the Commissioner of Internal Revenue." 26 C.F.R. § 601.101(a); *see also* 26 U.S.C. § 7803. The IRS is responsible for the implementation and enforcement of the internal revenue laws, including the Final Regulations. *See* 26 U.S.C § 7803. The IRS qualifies as an "agency" as that term is defined by 5 U.S.C. § 701(b)(1).

17. Defendant Charles P. Rettig ("Rettig") is the Commissioner of Internal Revenue. Defendant Rettig "has general superintendence" over the administration and enforcement of the internal revenue laws, including the rules and regulations at issue. 26 CFR § 601.101(a); *see also* 26 U.S.C § 7803. The claims against Defendant Rettig are asserted against him in his official capacity as the Commissioner of Internal Revenue.

18. The Court has personal jurisdiction over all Defendants.

## BACKGROUND

### A. New York Charitable Reserve Funds.

19. New York law authorizes the governing boards of counties, cities, towns, villages, and school districts to establish charitable gifts reserve funds. N.Y. Gen. Mun. Law §§ 6-t to -u (Consol. 2019); N.Y. Edn. Law §§ 1604(44), 1709(12-b), 2590-h(54).

20. At the end of the fiscal year, governing boards may "transfer the funds to the general fund or other fund of the municipal corporation, so that the funds may be used for charitable purposes." N.Y. Gen. Mun. Law §§ 6-t to -u (Consol. 2019); *see also* N.Y. Edn. Law §§ 1604(44), 1709(12-b), 2590-h(54).

21. New York law also permits municipal corporations that have established charitable gifts reserve funds to authorize a tax credit against real property taxes for taxpayers who contribute to the funds. N.Y. Real Prop. Tax Law § 980-a (Consol. 2019).

22. Pursuant to New York law, Scarsdale has established a charitable gifts reserve fund and authorized a related real property tax credit for taxpayers contributing to the fund. Village of Scarsdale Local Law §§ 269-35 to 269-38 (Consol. 2019).

23. Under Scarsdale's municipal laws, any owner of real property located within Scarsdale who makes an unrestricted charitable monetary contribution to its charitable gifts reserve fund may claim a credit against their Scarsdale property tax equal to 95% of the charitable gifts reserve fund donation. Village of Scarsdale Local Law § 269-35 (Consol. 2019). The remaining 5% of the contribution, no matter how large in amount, remains freely available for Scarsdale to use as it sees fit for its residents, including but not limited to the administration of its charitable gifts reserve fund.

**B. State and Local Tax Deduction Limitation.**

24. Section 164 generally allows an itemized deduction for the payment of certain taxes, including state and local real property and income taxes.

25. Congress added Section 164(b)(6) to the Code as part of "an Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." Pub. L. No. 115-97, § 11042, 131 Stat. at 2805–06 (Dec. 22, 2017).

26. Section 164(b)(6) limits an individual's deduction for the aggregate amount of state and local real property and income taxes paid during the calendar year to $10,000 ($5,000 in the case of a married individual filing a separate return) (the "SALT Deduction Limitation").

27. At the time of the enactment of Section 164(b)(6), Congress, Treasury, and the IRS were all aware of nationwide state and municipal programs, in some cases enacted years before Section 164(b)(6), permitting taxpayer transfers to funds controlled by state or local governments, or other specified transferees, in exchange for credits against the taxpayers' state or local taxes.

28. The SALT Deduction Limitation applies to taxable years beginning after December 31, 2017 and before January 1, 2026.

**C. The Contribution or Gift Deduction.**

29. Section 170(a)(1) generally allows an itemized deduction for any charitable contribution or gift paid within the taxable year, including a contribution or gift to or for the use of "a State, a possession of the United States, or any political subdivision of any of the foregoing." 26 U.S.C. § 170(c).

30. Judicial precedents, published guidance binding on the Defendants, and IRS administrative pronouncements have consistently held that the receipt of a tax benefit (*e.g.*, a state or local tax credit) in return for a contribution otherwise meeting the requirements of Section 170

does not give rise to a *quid pro quo* requiring the reduction of the amount of a charitable contribution deduction under Section 170.

31. As recently as 2010, the IRS affirmed this position. *See* IRS Chief Counsel Advisory 201105010 (Oct. 27, 2010) (the "2010 CCA").

**D. Treasury and the IRS Issue Proposed Regulations.**

32. On August 27, 2018, Treasury and the IRS issued a notice of proposed rulemaking and notification of public hearing (REG-112176-18, 83 Fed. Reg 43563) for proposed amendments to the rules governing charitable deductions under Section 170 (the "Proposed Regulations").

33. Breaking with judicial precedents, published guidance binding on the Defendants, IRS administrative pronouncements, and settled taxpayer expectations, the Proposed Regulations generally stated that if a taxpayer makes a payment or transfers property to or for the use of an entity listed in Section 170, 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 taxpayer's charitable contribution deduction (the "New *Quid Pro Quo* Rule").

34. The Proposed Regulations included a separate rule for state and local tax deductions, stating that they do not constitute a *quid pro quo* unless they exceed the amount of the taxpayer's payment or transfer (the "Deduction Exception Rule"). This is despite the fact that the amount allowed as a deduction, like the amount allowed as a credit, benefits the taxpayer economically.

35. The Proposed Regulations also included a rule under which a state or local tax credit is excepted from the New *Quid Pro Quo* Rule if the credit does not exceed 15 percent of the

taxpayer's payment or 15 percent of the fair market value of the property transferred (the "15 Percent Exception Rule").

36. In addition, the Proposed Regulations would amend 26 C.F.R. § 1.642(c)-3 to provide similar rules for payments made for a purpose specified in Section 170 by a trust or decedent's estate (the "Trusts and Estates Rule").

**E. September 5, 2018 "Clarifications" to the Proposed Regulations.**

37. On September 5, 2018, Defendant Mnuchin issued a press release concerning the proposed regulations.[2] In that press release, Mnuchin stated that "the longstanding rule allowing businesses to deduct payments to charities as business expenses remains unchanged . . . ."[3] He further stated that the Proposed Regulations have "no impact on federal tax benefits for business-related donations to school choice programs."[4]

38. On the same day, the IRS issued a "clarification" to the Proposed Regulations, affirming that business taxpayers who make business-related payments to charities or government entities that generate state or local tax credits may generally deduct the payments as business expenses without regard to the value of the tax credits received, so long as the payments qualify as ordinary and necessary business expenses under Section 162 (the "Business Entities Exception Rule").[5] Again, this is despite the fact that the "benefit" received in such circumstances is identical to the benefit received by a taxpayer making a charitable deduction to the Scarsdale fund.

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[2] Press Release, Department of the Treasury, Treasury Secretary Mnuchin Statement on Clarification for Business Taxpayers: Contributions Under State and Local Tax Credit Programs Generally Deductible as Business Expenses, *available at* https://home.treasury.gov/news/press-releases/sm472 (last visited Jul. 17, 2019).
[3] *Id.*
[4] *Id.*
[5] IRS News Release IR-18-178 (Sept. 5, 2018).

**G. Comments and Public Hearing.**

39. The Proposed Regulations invited the public to submit comments by October 11, 2018, and scheduled a public hearing for November 5, 2018.

40. In the less than two-month comment period, Treasury and the IRS received over 7,700 comments to the Proposed Regulations and 25 requests to speak at the public hearing.

41. Scarsdale, as a member of the Coalition for the Charitable Contribution Deduction (consisting of local governments, including counties, cities, towns, villages, and school districts, in the states of New York and New Jersey, along with state and countywide professional and advocacy organizations) submitted substantive comments during this period, and requested the withdrawal of the Proposed Regulations.

**H. Revenue Procedure 2019-12.**

42. On December 28, 2018, Treasury and the IRS issued Rev. Proc. 2019-12, 2019-04 I.R.B. 401, without notice and prior opportunity for comment.

43. Rev. Proc. 2019-12 provides safe harbors under Section 162 for certain 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 a state or local tax credit in return for such payment.

44. Under Rev. Proc. 2019-12, if a C corporation makes a payment to or for the use of an organization described in Section 170(c) (which includes political subdivisions of States, including Scarsdale) and receives or expects to receive a tax credit that reduces a state or local tax imposed on the C corporation in return for such payment, the C corporation may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of Section 162(a) of the credit received or expected to be received.

45. Under Rev. Proc. 2019-12, if a specified passthrough entity makes a payment to or for the use of an organization described in Section 170(c) and receives or expects to receive a tax credit that reduces a state or local tax imposed on the specified passthrough entity (other than a state or local income tax), the specified passthrough entity 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 credit received or expected to be received.

46. Neither a C corporation nor a specified passthrough entity is required in these circumstances to treat the state or local tax credit as a *quid pro quo* or as having any value for any purpose of the Code (the "Automatic Business Entities Exception Rule").

**I. Treasury and the IRS Issue Final Regulations.**

47. On June 11, 2019, Treasury and the IRS issued the Final Regulations.

48. The Final Regulations reject all material, substantive critical comments to the Proposed Regulations proffered in public comments and in the public hearing, leaving the text of the Final Regulations nearly identical to that of the Proposed Regulations.

49. Treasury and the IRS concede that the Final Regulations "generally retain the proposed amendments set forth in the [Proposed Regulations], with certain clarifying and technical changes." 84 Fed. Reg. at 27514.

50. The Final Regulations retain, without change, the New *Quid Pro Quo* Rule.

51. The Final Regulations retain, without change, the Deduction Exception Rule.

52. The Final Regulations retain, without change, the 15 Percent Exception Rule.

53. The Final Regulations retain, without change, the Trusts and Estates Rule.

54. The Final Regulations do not purport to alter the treatment of state and local tax credits for purposes of Section 162(a) or Rev. Proc. 2019-12, the "Business Entities Exception Rule" and the "Automatic Business Entities Exception Rule".

55. To justify the Final Regulations' break from settled law, Treasury and the IRS argued that failing to reduce charitable contribution deductions under Section 170 by received state and local tax credits would substantially reduce anticipated revenue gains from the newly enacted SALT Deduction Limitation; accordingly, Section 170 needed to be reinterpreted to avoid this result. *See, e.g.*, 84 Fed. Reg. at 27523 (asserting "[a] substantial amount of this revenue [*i.e.*, from the SALT Deduction Limitation] would be lost if state tax benefits received in exchange for charitable contributions were ignored").

56. By contrast, Treasury and the IRS determined that they could continue to ignore the tax deductions attributable to the same type of contributions because "the potential revenue loss" attributable to those deductions was "comparatively low." *Id.* at 27521.

57. Treasury and the IRS also claimed that the Final Regulations would have limited impacts on any charities because "90 percent of taxpayers will not claim itemized deductions of any kind" and so these taxpayers "are entirely unaffected by this rule" and will have the same incentives to contribute to charities as before. *Id.* at 27528.

**J. Treasury and the IRS Issue Notice 2019-12.**

58. On June 11, 2019, and without notice and the prior opportunity for comment, the Treasury Department and the IRS also issued Notice 2019-12, 2019-27 I.R.B., providing yet an additional safe harbor. Under this safe harbor, an individual who itemizes deductions and makes a payment to a Section 170(c) entity in return for a state or local tax credit may treat the portion of such payment that is or will be disallowed as a charitable contribution deduction under the Final

Regulations as a payment of state or local tax for purposes of Section 164, meaning that despite the supposed "*quid pro quo*," the payment remains deductible for federal income tax purposes so long as the taxpayer has additional room under the $10,000/$5,000 state and local tax deduction cap.

**K. The Administrative Procedure Act.**

59. The APA affords adversely affected parties the opportunity to seek review of final agency actions for which there are no other adequate remedies in a court.

60. The Final Regulations constitute final agency action subject to the APA.

61. Under the APA, courts must "hold unlawful and set aside agency action, findings, and conclusions" that the court finds to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law" or "in excess of statutory jurisdiction, authority, or limitations, or short of statutory right." 5 U.S.C. § 706(2)(A), (C).

**INJURY TO PLAINTIFF**

62. Defendants' promulgation of the Final Regulations has caused ongoing, legally cognizable harm to Scarsdale.

63. Scarsdale's charitable gifts reserve fund received over $500,000 in 2018 contributions prior to the issuance of the Final Regulations, of which $25,000, or five percent of these contributions, was made available to Scarsdale for use as it saw fit for its residents, including for the administration of its charitable gifts reserve fund. Since Defendants issued the Final Regulations, no further contributions have been made, depriving Scarsdale of the 5% of non-creditable contributions that it would have otherwise received above and beyond any real property taxes assessed and collected.

64. The lack of further contributions to Scarsdale's charitable gifts reserve fund is directly attributable to Defendants' unlawful regulatory actions.

65. Moreover, and notwithstanding the lack of further contributions, Scarsdale continues to legally bear the cost of administering its duly-enacted charitable gifts reserve fund, both in real dollars and in diverting other, limited municipal resources to the fund's administration.

66. Other than an action in this Court, Plaintiff has no alternative means by which it may challenge the Final Regulations.

## CAUSE OF ACTION

### The Final Regulations are Arbitrary, Capricious, an Abuse of Discretion, and Otherwise Not in Accordance with Law.

67. Plaintiff repeats and re-alleges the factual and jurisdictional allegations in this complaint.

68. The APA provides that agency actions are to be set aside when found to be arbitrary, capricious, an abuse of discretion, unsupported by substantial evidence, unwarranted by the facts, or without a statutory basis. 5 U.S.C. § 706(2)(A), (C).

69. The Final Regulations lack statutory authority and are contrary to the plain text of Section 170. Congress had the opportunity to amend Section 170 to address the purported concerns of the Final Regulations, but chose not to do so. Had Congress wished to upend more than a century of practice and precedent, it alone would have done so and would have done so in clear terms. Rather, Treasury and the IRS sought to superimpose their own designs on Section 170 to allegedly safeguard tax revenue streams. This impermissibly arrogates congressional authority.

70. The Final Regulations arbitrarily and capriciously conflict with binding judicial precedent and the IRS's own administrative guidance regarding the characterization and treatment of state and local tax credits. Treasury and the IRS use the Final Regulations as a vehicle to

circumvent judicial review of what is, in essence, an altered and spurious litigation position. By ignoring meaningful comments identifying the unreasonableness of this approach, Treasury and the IRS manifest that the Final Regulations were predetermined and prepared merely under the guise of purportedly reasoned decision-making.

71. The Final Regulations arbitrarily and capriciously characterize the receipt of state and local tax credits differently for purposes of Section 170 than for all other provisions of the Code. For example, if state and local tax credits were "return benefits" under the Code, as they are under the Final Regulations, they should also be treated as items of gross income under Section 61. Since they are not, the Final Regulations are by definition arbitrary and capricious.

72. The Final Regulations' failure to provide a reasoned distinction between tax benefits in the form of credits and tax benefits in the form of deductions is arbitrary and capricious because that distinction is irrational. Credits and deductions are benefits designed to promote charitable giving. At most, the difference between tax credits and tax deductions is a difference in degree, not a difference in kind. It follows that a system that disfavors tax credits while favoring tax deductions that are aimed at the same goal is impermissibly arbitrary.

73. The Final Regulations arbitrarily and capriciously treat individuals and businesses differently in substantively identical circumstances, as evidenced by the "Business Entities Exception Rule" and the "Automatic Business Entities Exception Rule".

74. The Final Regulations' 15 Percent Exception Rule arbitrarily and capriciously creates disparate results in substantively identical circumstances. A taxpayer who makes a contribution that triggers the receipt of a state and local tax credit worth 15 percent of the donation or less may claim a deduction for the full contribution, while a taxpayer who makes a contribution that yields a tax credit worth *one cent* more than 15 percent of the donation, regardless of dollar

amount, must subtract the value of the *entire* credit from the deduction. This "cliff effect" treatment is arbitrary and capricious.

75. The safe harbors and carve-outs contained in IRS News Release IR-18-178, Rev. Proc. 2019-12, and Notice 2019-12 are baseless and illogical. Because those agency rules are inextricable appendages to the Final Regulations, and because they additionally skirted notice and comment requirements, they render the Final Regulations arbitrary and capricious.

76. The Final Regulations are arbitrarily and capriciously predicated on false assumptions regarding their impact on taxpayer charitable donations and local charities. Treasury and the IRS maintain "this rule will leave charitable giving incentives entirely unchanged for the vast majority of taxpayers" because "90 percent of taxpayers will not claim itemized deductions of any kind" and are thus "entirely unaffected by this rule." *Id.* at 27528. However, Treasury and the IRS fail to consider how the Final Regulations may affect a taxpayer's: (1) decision to itemize or take the standard deduction and (2) incentives to make additional charitable contributions. Taxpayers who itemize have greater economic incentive to make charitable contributions than taxpayers who claim the standard deduction, as they are the only ones who can benefit from the charitable deduction. By disallowing deductions for contributions that trigger state and local tax credits, the Final Regulations reduce the pool of taxpayers who will exceed the standard deduction threshold, and for whom there would otherwise be economic incentive to make additional charitable contributions. It follows that the Final Regulations reduce incentives to contribute to *any* charitable institutions for a larger pool of taxpayers than Treasury and the IRS contend. Treasury and the IRS's incorrect assumptions and failure to account for this shift in incentives render the Final Regulations fundamentally flawed and completely undermines their rationale.

77. The Final Regulations are not the product of reasoned decision-making.

78. The Final Regulations lack a reasoned explanation or justification.

**PRAYER FOR RELIEF**

WHEREFORE, the Plaintiff demands (1) a final judgment declaring that the Final Regulations are invalid pursuant to 5 U.S.C. § 706; (2) an order holding unlawful and setting aside those regulations under the APA; and/or (3) such other and further relief as the Court deems just and proper.

Dated: July 17, 2019

Respectfully submitted,

s/ Daniel A Rosen
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(Motion for Admission Pro Hac Vice Pending)
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