

## A Win-Win Option for Charity and Tax Policy

C. Eugene Steuerle

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Stories of abuses by both donors to charities and by charitable organizations have once again filled newspaper headlines recently. The types of abuse are multiple, stretching from overvalued donations of easements (restrictions on certain uses of land to protect it, say, for conservation purposes) to vacations financed by donations of dead animal heads to the storage rooms of museums. The commissioner of the IRS, Mark Everson, comes close to admitting that his organization cannot administer or monitor the system as it now stands. George Yin, the chief of staff of the Joint Committee on Taxation, suggests that charitable deductions for contributions of appreciated property be equal to the taxpayer's basis in the property.

Predictably, some parts of the charitable sector want to go on the defensive, warning of the danger of overreaction. Although this approach at times reflects legitimate concerns, overall it is a mistake. The charitable sector should be known as representing the public. It should be taking the lead -- not merely following and certainly not engaging in rear-guard reaction -- in attacking internal abuses. If it cares about the public, as it claims, then it must also care about principles of tax policy and the viability of tax administration.

In every crisis there is opportunity, and, in this case, it has been provided by Sen. Chuck Grassley, R-Iowa, chairman of the Senate Finance Committee. Among the announcements that has not gathered much publicity was his offer to seek ways to blend together a clean-up of the charitable sector with additional charitable incentives. One part of the package would focus on curbing problems with charitable giving and governance. The other would include the types of items contained in a charitable incentive bill that has been evolving since first suggested by President Bush in his 2000 campaign. A combined package of this type could be a clear win-win: good tax policy and good charitable policy. Done the right way, it could significantly increase charitable giving, improve tax compliance, and remove some of the sources of cheating and corruption sometimes associated with charitable giving.

Not every charity will be happy with the trade-offs required, so some courage will be required by charitable sector leaders to take full advantage of Sen. Grassley's suggestion. But I am hopeful here as well. Despite the defensiveness of some, others within the sector have responded positively to recent Senate Finance hearings and suggestions. At least so far, many of its members have tried to take on the mantle of good public policy rather than, as has occurred so often, the cloak of a trade association.

What's the trick here? How can this offer by Sen. Grassley be made a win-win scenario? It's simple. A fair amount of cheating takes place when it comes to charitable giving. On top of that problem, the incentives in the tax system are not well-designed. For the amount of revenues foregone, much more charitable giving could be generated. The revenues spent on cheaters and on that portion of giving unlikely to be responsive to an incentive could be reallocated toward giving that is more likely to be responsive. Meanwhile, these reforms could be done in a way that allows IRS to better monitor claims of charitable deductions, reduce opportunities to overvalue gifts, and remove opportunities for some taxpayers to declare deductions for giving that never took place. The net result: better tax policy, better tax administration, and a stronger charitable sector. Perhaps most importantly, an intangible: a sector with improved integrity, one that comes to represent better the public it claims to serve.

In Senate Finance hearings on the charitable sector in 2004, I submitted a suggestion that the two efforts be combined, but without much in the way of details. However, in an earlier Senate Finance testimony in 2001, I testified on some ways that additional incentives, such as a deduction for nonitemizers, might best be designed to provide the maximum increase in charitable giving per dollar of revenue involved. Now that the chairman has indicated his interest in this type of trade-off, it would be of great value to figure out precisely

how to put together the details.

Here is one example of how a package might be put together:

#### Improved Compliance and Revenue-Raising Options

- Require 1099 reporting to the IRS by charities on some, most, or all donations received (starting with gifts greater than \$250, where such reports already must be made to taxpayers);
- Require that charities verify or place valuations on many, most, or all types of in-kind gifts, and, for the most part, that the taxpayer use that valuation when reporting charitable donations.
- Limit deductibility for in-kind gifts where the net amount to charity is so low (because of payments to intermediaries) that the revenue cost to government is greater than the value of the gift made. Require also that the charity must report to the taxpayer on net amount received after payment to intermediaries, including advertisers, if this amount is less than, say, 50 percent of the value of the gift;
- Place limits or remove deductibility on cash contributions for which there is no check, credit card, receipt by charity, or any other document that an IRS auditor could verify
- Place a floor under charitable giving (for example, 1/2 percent of income), with deductions allowed only for gifts above that amount. For simplification purposes, this floor should be the same for all taxpayers, so that if a deduction is extended to nonitemizers, there is only one place on the tax return that these calculations are made. Most bills now in Congress extending the deduction are way too complex, requiring calculations in two places. In particular, they require taxpayers to compare alternatives so as to decide whether to take deductions as itemizers or nonitemizers, a calculation in turn affected by all sorts of provisions such as the phaseout of itemized deductions.
- Require full public disclosure by fund-raising intermediaries of the amount of gifts raised for each charity, the amount they, the intermediaries received, the amount paid to other intermediaries, including for advertising, and the net amount turned over to the charity. These returns would be publicly available, just like the 990 returns of charities.

Not all options to reduce cheating involve changes in the law. Some foundations could and, in my view, should band together to fund much more fully various watchdog groups. Where these groups find abuses, they need to be given the additional resources to make that information available to the public through advertising or press contact. The public shaming of a few charities engaged in outrageous fundraising efforts, as well as some of the media outlets that welcome misleading advertising, for instance, would go a long way to induce other charities not to engage in herd behavior so they can get their share of some dubious bounty.

OK, I know I'm in hot water now. Although these suggestions would greatly improve compliance and make it possible for the IRS to better monitor and audit returns, some charities and fund-raising intermediaries might fear they would lose out for some of their activities.

Anecdotal complaints, however, are no basis for determining the worth of an entire package nor the net cost of leaving out any particular option. A very neat part of the Grassley proposal is that in a revenue-neutral world, rejecting these types of proposals reduces the amount of revenue that can be spent on increasing charitable giving in a more efficient way. Thus, leaving out an option often means winning a battle and losing the war because it reduces the amount of charitable giving. All the compliance and revenue-raising options noted above are targeted to areas where there is a fair amount of cheating, misleading advertising, weak ability to enforce, and limited portions of contributions actually making their way to charitable purposes.

One needs to test different options. Consider the option to put a floor under deductible giving. Such a floor likely would have almost no effect on giving because it does not apply at the margin to additional giving that might be made. Economists have shown that incentives apply best on margins where people might do more rather than to actions that they would take anyway in absence of any incentive. A floor also helps the Service with compliance where only small amounts of money are at stake. Therefore, an even higher floor than offered above ought to be considered, since it could raise even more revenues that could be spent on charitable incentives that would increase giving.

Some of the revenue raising proposals -- even with no offset -- might increase the net amount of charitable giving. Someone giving away, say, an automobile with a wholesale value of \$3,000 might alternatively sell the automobile and give the \$3,000 to charity, or make charitable contributions of \$2,500 if she had not given the automobile away. If only \$1,000 on net is making it to the charity when the automobile is given away because of all the fund raising and advertising costs, then the net amount for charitable purposes has actually gone down. At a broader level, people are tired of reading about abuses of the charitable sector in areas like automobile donations, clothes donations, and easement rights. A sector that demonstrates more integrity in such areas is one that in the long run might very well attract more giving.

Now let's think about how we can spend this money in a more efficient and fairer way that likely would increase charitable giving. Here are some options:

- Extend the charitable deduction to all taxpayers (subject to a floor, as noted above).
- Raise the 50 percent limit on charitable giving and/or allow more flexible carryover to later years.
- Allow contributions to be made directly from individual retirement (IRA) and similar accounts (which, among other things, would allow easy automatic withdrawal and redeposit options to be implemented by mutual funds handling retirement accounts and donor-advised funds).
- Reduce and flatten the foundation excise tax (all of which effectively increases the amount going for charitable purpose).
- Give charitable contributions the same treatment as deposits to IRAs and allow deductions up to April 15, but only for charities willing to provide full 1099-type reporting to IRS. The notion here is that the "advertising"

value of the donation is significantly enhanced when taxpayers are filling out their returns and can immediately see the consequences of their actions.

Each of these options likely would increase significantly charitable donations (or in the case of foundations, grants). In many cases, charities that might be reluctant to take on the first set of options would find that they are much better off with the package than without it. For instance, the additional reporting requirements make it easier to allow giving to April 15, which I believe would increase giving because it markets the tax incentive at the time the tax return is filed. A restriction on cash contributions, which might at first appear to affect churches, is likely to be more than offset in value by the extension of a deduction to nonitemizers. Keep in mind that in churches, larger givers usually make use of envelopes or pledges, while those giving only modest amounts of cash are likely to be nonitemizers anyway.

On some of the options noted above, it will be hard to come up with a perfect revenue estimate. This places some risk that the revenue given away will be greater than or less than the revenue raised. I am reminded of the time in the 1980s when Congress required that Social Security numbers be reported for dependents. IRS research staff had long argued that there was substantial cheating here but had trouble coming up with an exact figure, even from their own audits. It turned out that there was much more than many expected, and the revenue estimate was wrong. To me, however, the inexactitude of the revenue estimates places little risk that the package would decrease giving. Moreover, if desired, it would be possible to give regulators some authority to reduce a floor under deductions in some automatic fashion for future years when the total amount deducted in a given year came out to be less than some targeted amount.

Sen. Grassley has offered to the charitable sector a golden opportunity to enhance its public image and increase charitable giving, all the while improving public and tax policy, as well as tax compliance. Admittedly, there will be a counter-reaction by those who find it risky to change the status quo. But given the opportunity to spend more efficiently and fairly tax subsidies that are now spent less effectively, no real entrepreneur for improving the charitable sector should make light of the magnitude of the possibilities at hand.

## Other Publications by the Authors

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- [C. Eugene Steuerle](#)

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