Tax Policy and Charities
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# Legislative Options for Simplifying and Restructuring the Charitable Deduction

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*December 2012*

This project is funded by the Bill & Melinda Gates Foundation, Charles Stewart Mott Foundation, the Rasmuson Foundation, and other donors. The findings and conclusions contained within are those of the author and do not necessarily reflect positions or policies of our funders.

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Section 170 of the Internal Revenue Code (Charitable etc., Contributions and Gifts) now contains 16 subsections divided into 75 paragraphs and who knows how many subparagraphs. The CCH version of Section 170 and its legislative history takes up 35 pages. In addition, much of this voluminous statute is difficult to parse.

Further, there is very little order to the provision. For example, rules requiring substantiation of the deduction can be found in paragraphs 8, 11, 12, 17, and 18 of subsection (f) (Disallowance of Deductions in Certain Cases and Special Rules), sometimes combined with substantive rules. Subsection (f) also contains several provisions relating to gifts of a partial interest, beginning with paragraphs 2 through 4, with later rules added in 7, 13, and 14. Subsection (f) also prescribes a mélange of unorganized restrictions on the deduction in paragraphs 1, 5, 6, 9, 10, 12, 15, 16, and 18.

The charitable deduction for estate and gift taxes for the most part provides identical rules. Yet a number of mostly minor differences are not readily apparent.

Hence, not surprisingly, when asked by the NYU Program on Philanthropy and the Law to prepare a paper, "Complexity and Structural Reform," for a conference on the charitable deduction, I responded with an attempt to reorganize and, where possible, simplify the rules of section 170. While I would not expect my revision to be enacted, I believe it could increase understanding and thereby enhance the possibility of both reform and simplification.

My proposed draft suggests some substantial changes, perhaps most significantly by reducing the number of percentage limits on the charitable deduction to two, which significantly shortens 170(d). I also propose general uniformity for income, gift, and estate tax deductions, which, perhaps most important, would deny any estate tax deduction for a transfer of an undivided interest in property. For the most part, however, rather than reflecting my views, the draft in substance follows present law. Potential modifications are presented in the section-by-section analysis of the proposed draft, which follows the proposed code revision. The principal issues are discussed next.

## Restructuring

The incoherence and complexity of Section 170(f) is remedied in a number of ways. First, new Section 170A collects all the rules on partial interest gifts. In addition to the provisions of subsection (f) noted above, this section incorporates section 170(a)(3) (future interests in tangible personal property), 170(h)(conservation easements), and 170(o)(gifts of undivided interests). Second, new 170B includes all the substantiation rules of subsection (f), noted above. Third, as described below, section 170(a) collects the special valuation rules for the charitable deduction, including the requirements for vehicle donations now in subsection (f). While the line is not absolute, the restrictions on the deduction that do not seem valuation related remain in subsection (f) along with the provisions now in section 170 (j), (k), and (l). These provisions are reordered in accordance with the purpose of the rule.

I have expanded section 170(a) in an effort to include all provisions that provide special valuation rules for the charitable deduction, including the election under (b) to limit deduction to basis and the limits on the deduction for capital gain property now under subsection (e). Subsection (e) is limited to treatment of donations of ordinary income property, which do not seem to be primarily valuation focused.

## Uniform Rules–Income Tax Exemption–Charitable Deduction Income, Gift and Estate Tax

Current section 170(c)(2)(relating to eligible recipients of charitable contributions) is, apart from subparagraph (A) requiring a domestic corporation, identical to section 501(c)(3)(relating to organizations exempt from tax) except that the latter includes organizations testing for public safety. I suggest removing the reference to organizations testing for public safety from section 501(c)(3) and amending section 170(c)(2) to directly incorporate section 501(c)(3). A domestic organization is now required for income tax purposes and bequests and gifts by nonresidents (except for gifts used in the United States). It is not required for bequests or gifts by residents. No change is proposed.

On the other hand, most current distinctions regarding eligible recipients are eliminated. For example, I would delete the income tax deduction for contributions to cemetery companies, which does not exist for gift and estate, and the estate tax deduction for transfer to an ESOP. However, it is not possible to amend the estate and gift tax provisions to refer directly to deductions that would be allowed under section 170(a). Because the gift and estate deductions merely prevent a tax on the amount of the transfer, rules that do not allow a fair-market value deduction (such as the special rules of current section 170(e)) because of concerns over valuation or as an indirect tax on appreciation would be inappropriate if the result would be to subject an **unequivocal** transfer to tax.

Thus, sections 2055(a)(estate tax residents), 2106 (estate tax nonresidents), and 2522(a) (gift tax) instead allow deduction for contributions to organizations described in section 170(c). Therefore, it becomes necessary to insert relevant restrictions on the tax deduction into the estate and gift provisions. The gift and estate statute now contains some of these restrictions—for example, 2055(e)(2) limiting the deduction for gifts of a partial interest—and I have added others that seem appropriate.

Current section 170(o) requiring recapture of the deduction for gifts of undivided interest, if the gift is not completed within 10 years or by the donor's death, is now applicable for gift tax but not estate tax. Since 170(o) requires gifts of undivided interests to become a complete gift by the donor's death, it would seem an estate tax deduction for an undivided interest would be inappropriate. The draft so provides.

Both the estate and gift tax liberalize two restrictions on partial interest gifts, allowing a work of art and copyright to be split and eliminating the requirement of section 170(h)(4) that an allowable partial-interest gift be for conservation purposes. Since I have seen no credible explanation for a difference from the income tax rules, the draft deletes these exceptions.

## Gifts of Property

Property gifts are problematic for two unrelated reasons. First, if the property has appreciated, it is unfair to allow a fair-market value deduction without recognition of the unrealized gain. Second, the charitable deduction may not reflect the value to the donee, perhaps even if it reflects the decline in the donor's assets. These distinct purposes are sometimes confused.

Thus, while the rules in current subsection (e), limiting the deduction to basis in specified circumstances, would appear designed to limit the advantage of donating appreciated property without gain recognition, in fact these rules as they relate to assets potentially producing long-term capital gain generally arose out of valuation concerns. The treatment of taxidermy and intellectual property, in fact, seems solely focused on valuation issues. The treatment of intellectual property is a close cousin to the rules for gifts of automobiles; the intent, in both cases, being to limit the donor's deduction to the amount actually received by the charity. Collecting these rules in section 170(a) could focus attention on developing a more uniform approach to valuing property gifts, perhaps expanding the circumstances where the actual benefit to the donee governs the deduction or completely denying a deduction for gifts of low value such as clothing, household goods, or automobiles below $500 and for all taxidermy property. I have, however, left the ordinary income provisions, which do not seem based on valuation issues, in Section 170(e), which would then deal only with ordinary income property.

This paper does not generally propose new initiatives that are not related to simplifying or "reconciling" existing rules, but I wish to note my proposals for modifying the deduction for conservation easements.[1] These papers suggest replacing the charitable deduction with a limited dollar tax credit. If this is rejected, I suggest limiting qualified donees to organizations that hold a substantial number of easements and have sufficient staff and resources to monitor and enforce compliance, limiting the deduction to a conservation value certified by a qualified organization and imposing an excise tax on those that do not monitor compliance.

[1] See Daniel Halperin, "Incentives for Conservation Easements: The Charitable Deduction or a Better Way," *Law and Contemporary Problems* 74 (2011); and Daniel Halperin, "Shelf Project: Replace the Charitable Deduction for Conservation Easements with Limited Refundable Tax Credits," *Tax Notes* (July 16, 2012).

## Gifts of Ordinary Income Property

These rules are enormously complex, and the several special rules for contributions of inventory are difficult, if not impossible, to distill into one overall rule. I support repeal of all the special rules, restoring the original rule that would reduce the deduction by the full amount of potential ordinary income in all cases. Alternatively, although I do not recommend it, we could increase the deduction for all gifts of ordinary income property to achieve parity (that is the same net after-tax cost) with gifts of capital gain property. This would require allowing a deduction for that portion of the appreciation equal to the ratio of the capital gain rate to the ordinary income rate, which for taxpayers in the highest bracket would be 42.85 percent (15 divided by 35 = 42.85). Thus, the deduction would be reduced by 57.15 percent of the potential ordinary income. Unfortunately, since the percentage would vary with the taxpayer's marginal rate, this method is impractical unless we return to the section 1202 approach of a uniform deduction for qualified capital gain.

## Percentage Limit on Income Tax Deduction

The complexity of the multiple limits arises from two policy decisions: first to favor contributions for gifts to (and not for the use of) certain so-called public charities; and second to provide lower limits for gifts of appreciated property.

Since, I believe the ability to take a fair-market deduction, without recognizing an unrealized gain, is abusive, I would want to continue to favor cash gifts. Thus, at least two separate limits are required. Two ways to provide only two limits are suggested:

1. Eliminate the distinction among donees and allow the 50 percent limit for all cash gifts regardless of donee and apply the 30 percent limit to all appreciated property transfers, whether or not to public charities. It is not suggested in the draft.
2. Combine the two current 30 percent limits for gifts of appreciated property to public charities and cash gifts to other institutions into one combined 30 percent limit. Under current law, as I understand it, it is possible to take a charitable deduction for up to 50 percent of adjusted gross income, even if all contributions are either in appreciated property or to private foundations etc., since there are separate 30 percent limits for each. Apparently, this reflects a feeling that each type should be disfavored by not allowing the full 50 percent deduction, but if neither type exceeds 30 percent there is no problem even if the combined amount reaches 50 percent. However, I think it is also possible to believe that a combined contribution of over 30 percent is problematic. The draft reflects this approach and, in the interest of simplification, eliminates the special 20 percent limit now applicable for donations of appreciated property for the use of rather than to public charities, traded shares to private foundations and as contributions to war veterans' posts, fraternal societies, and cemetery companies. Elimination of the deduction for transfers to fraternal societies and cemetery companies, as the draft proposes, makes this liberalization less problematic.