The Tax Treatment of Charities & Major Budget Reform

Statement of

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Mr. Chairman and members of the Committee:

It is an honor once again to testify before you, this time on the relationship among budget reform, tax reform, and the tax incentives for charities. Like almost everyone, I am involved with the charitable sector in many ways—in my case, as researcher or analyst, donor, chair of a community foundation, and employee. You have asked me here in my first role, and I will strive, as I always have, to try to present you the best information in as objective a way as possible.

Almost no person or institution can fail but be intimately involved and affected by the huge tasks before this Congress—getting our long-run budget in order, reducing unemployment, and simply making government work. You sit, I believe, at the beginning of one of the major fiscal turnings in our history. By fiscal turning, I refer to a period where government must gain or regain the fiscal space, give, or slack to be able to move forward confidently to meet the needs and demands of an unknown future. That we must go through this turning is unavoidable; that it will be done well is yet to be determined. And the stakes are huge.

Our mutual goal in the midst of this uncertainty should be to enhance the strength and capabilities of all sectors of our economy. Each has a vital part to play. With regard to budget or tax policy and charities, both public and private sector have clear responsibilities:

> The foundation community and charitable sector should provide leadership to help us face up to our duties, make tough choices, and move beyond narrow interest considerations that can pull us down together.
>
> Those deciding or influencing government policy, in turn, should be seeking policy solutions that strengthen the budget, develop a fairer and more efficient tax system, and strengthen all the sectors of the economy, including business, household, and nonprofit.

These goals are compatible.

Let me also be clear. *Reforming budgets so that they have fewer long-term deficits only creates net losses in the political, not economic, sense.* Real budget reform simply means moving to a system where we pay our bills, or incur fewer of them, rather than shift ever more of them off to unidentified taxpayers in the distant future. In that sense reform merely makes visible the hidden parts of a balance sheet. Done well, it creates the net winnings that come from a more vibrant economy, which can benefit all sectors.

In most of my testimony, I compare and contrast various proposals according to their effect on charitable giving and revenues. Before proceeding, however, I wish to lay aside three issues:

- A charitable incentive may be desired for reasons that go well beyond any incentive effects we can measure, including sending a positive signal about the type of society we seek and our duties to one another.
- Progressivity is best assessed by the overall structure of the tax system, or, more precisely, of taxes and spending, not by each individual provision.
- Government interacts with charities in many ways, and what it does through direct spending or tax rates generally will have more impact than changes in tax incentives.

Promoting Altruism and a Civil Society

Government funding of acts of generosity encourages many good things in society that go beyond a mere transfer of resources. It promotes a general spirit of giving and the development of mediating institutions. This type of signaling effect is measured poorly by the types of statistical analysis we normally perform, which generally try to determine how much modest differences in tax incentives affect giving.

Promotion of charity is also viewed as a way that a capitalistic society reduces the tensions that arise from the unequal distribution of power and wealth. If the charitable deduction also promotes a more altruistic society, the gains to society relate not just to benefits transferred to ultimate donees, but to the behavior of the donors.

In your deliberations over budget and tax reform, therefore, I strongly encourage you to give attention to the message you convey about the type of society you wish to encourage.

Progressivity

To measure progressivity, one has to define the base by which it is measured. We could measure it along a scale of income by itself or income available to consume after taking into account certain transfers such as alimony or gifts to charity. In the latter case, charitable deductions do not reduce progressivity any more than do deductible payments of alimony. Unlike alimony, on the other hand, charitable giving is seldom taxable to the ultimate beneficiaries of the transfer, so it still provides a subsidy, but by this standard, to the recipients.

For the moment, however, let's measure progressivity along a scale of income alone. Even then, a charitable deduction need not reduce progressivity.

To see this, imagine a tax system with four taxpayers. Taxpayers A and B each have $100,000 in income and have a higher tax rate than taxpayers C & D, each with $40,000 in income. Suppose only taxpayers A and C give money away to charity. In Figure 1 below, I show that a tax regime with a charitable deduction and one without a deduction can be made equally progressive.

This is not just a hypothetical issue; it has real world applications. When I served as the economic coordinator of the Treasury project that led to the Tax Reform Act of 1986, some Treasury staff initially produced draft explanations of proposed reforms of particular tax subsidies. They wanted to argue that reforming some of these programs would make the tax system more progressive. However, the reform was designed so as to leave the distribution of taxes the same among those in different income classes, as measured on an income (pre-deduction) basis. Accordingly, any change in deductions, credits, preferences, and adjustments to the tax base was immediately offset by a change in the tax rate schedule to produce the same degree of progressivity.

Figure 1

Two Equally Progressive Tax Systems				
Taxpayer	Income	Charity	Tax	
			Regime 1	Regime 2
A	$100,000	$10,000	$18,000	$19,000
B	$100,000	$0	$20,000	$19,000
Total A + B			$38,000	$38,000
C	$40,000	$4,000	$3,600	$3,800
D	$40,000	$0	$4,000	$3,800
Total C + D			$7,600	$7,600

The Government-Nonprofit Relationship

The government interacts with charities and nonprofit institutions on a variety of fronts. Many of its payments flow through charities and provide health, education, and other forms of social welfare. Indeed, more money flows to charities from government fees and contracts than from individual and corporate contributions. Also, the setting of tax rates largely must be determined by considerations that stretch well beyond the charitable sector, yet they may have as much or greater effect on the sector as reforms made to the deduction itself.

When Congress allows an incentive like the current deduction, it permits taxpayers to choose how to allocate subsidies, but only within a set of boundaries surrounding what it deems to be charitable. However, Congress still picks winners and losers more directly through its direct grants and subsidies: for example, nonprofit hospitals over education for the young. There is no doubt as to whether Congress will pick winners; the question is whether it wants to maintain as part of its overall system a portion where it encourages individuals to give and, through their giving, pick the recipient organizations for some government money, as well.

Reforming Charitable Incentives

One of the practical difficulties with broad-scale budget reform is that it very big decisions often are made quickly, with officials often picking items off of a list to achieve some fiscal goal. When general limitations are made to apply across programs, such as a simple limitation on all itemized deductions (but not exclusions), they often don't end up providing the fairest or most efficient way of achieving the objectives of each particular program, even if, as a composite, the reformed law from a budget perspective might still be better than the status quo.

I also recognize the power of the status quo and the fundamental difficulty of all policy reform: that it creates losers as well as winners even if the net gains to society would be quite positive.

Still, I would like to lay out for you how a detailed reform of charitable tax law can be pulled together in a way that might achieve several of your longer-term objectives in ways superior to the shortcut method. In fact, it is quite possible to undertake reform that both cuts back on the cost of the charitable deduction and raises revenues.

In Figure 2 below I rank different tax reform options that raise revenue by the relative size of their negative impact on giving relative to amount of revenue gained. I include the failure to take certain actions—not allowing giving through April 15, and not allowing a deduction for non-itemizers—in this list since they, too, effectively "raise" revenues relative to their adoption.

The bottom line is that some actions, such as a floor under giving (say, only allowing deductions for giving above 1 percent), tend to raise substantial revenues with minimal impact on giving. Other options, such as not allowing people to continue to make deductions up until they file their returns on April 15, probably loses at least $3 of charitable giving for every $1 of revenue gained by denying this privilege. Capping the deduction or converting the deduction to a credit likely creates a greater loss of charitable giving than do some limitations on the deduction because they affect taxpayers who are considered by some researchers to be more sensitive to tax incentives.

Figure 2

A Preliminary Ranking of Restrictions on Giving by
Loss in Charitable Giving Per Dollar Pick-Up in Revenue

--Rough Ranking from Highest to Lowest--

- Undertaking greater compliance efforts
  - It is even possible for improved compliance to increase charitable giving
- Not allowing giving until April 15
  - Perhaps $3 to $6 dollars of giving lost per dollar of revenue pick up
- Capping the deduction or converting to a revenue-raising credit
  - Greater loss of charitable giving if higher-income givers more "price" sensitive
  - Result for a credit sensitive to the credit rate
- Excise tax on foundations
  - $1 loss in giving per $1 pick-up in revenues
- Not allowing a non-itemizer deduction
  - Less loss of charitable giving if lower-income givers less "price" sensitive
- A floor under charitable giving
  - Very limited loss of charitable giving per dollar of revenue pick up

Figure 3, summarized in the chart in Figure 4, shows you several types of changes to charitable tax law standardized to produce approximately $10 billion in revenues each. Though my reading of the literature implies a higher response rate for proposals that tend to affect those with higher incomes (because they have more at stake), there is no consensus on the matter, and through the Urban-Brookings Tax Policy Center we present results two ways that have been used by such agencies as the Congressional Budget Office[1]:

[1] The "low response" category uses a price elasticity of charitable giving of -0.5, and the "high response" category uses an elasticity of -1.0.

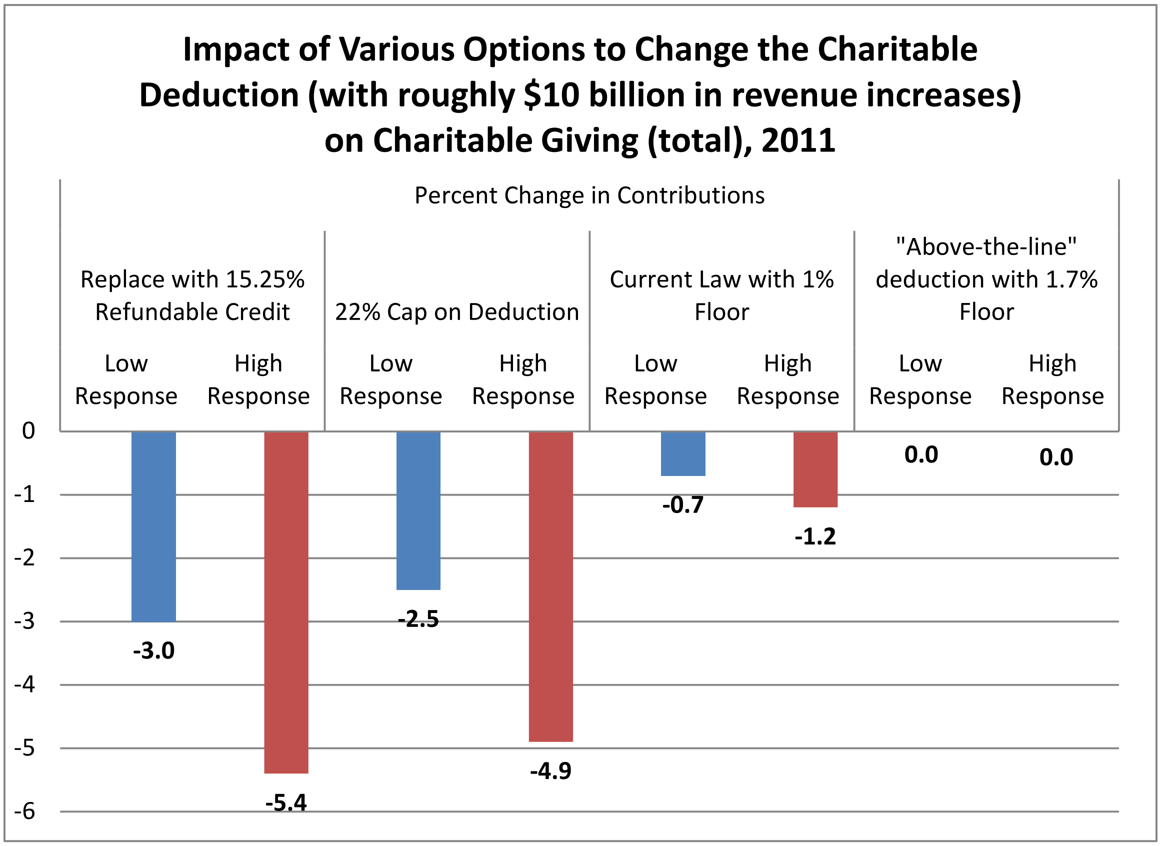
Figure 3

Impact of Various Options to Change the Charitable Deduction on Charitable Giving, 2011

Cash Income Percentile	Baseline Contributions ($ millions)	Percent Change in Contributions							
		Replace with 15.25% Refundable Credit		22% Cap on Deduction		Current Law with 1% Floor		"Above-the-line" deduction with 1.7% Floor	
		Low Response	High Response	Low Response	High Response	Low Response	High Response	Low Response	High Response
Lowest Quintile	**3,048**	8.6	18.5	0.0	0.0	0.1	0.7	0.6	1.5
Second Quintile	**9,480**	7.3	15.2	0.0	0.0	0.0	-0.1	3.6	4.2
Middle Quintile	**21,118**	4.7	9.8	-0.1	-0.1	-0.2	-0.4	2.9	3.9
Fourth Quintile	**40,221**	1.1	2.4	-0.4	-0.7	-0.5	-0.9	1.2	3.0
Top Quintile	**126,428**	-6.6	-12.6	-3.8	-7.5	-0.9	-1.6	-1.1	-2.0
All	**200,323**	-3.0	-5.4	-2.5	-4.9	-0.7	-1.2	0.0	0.0
Addendum									
80-90	**31,135**	-3.0	-5.7	-1.4	-2.7	-0.7	-1.3	0.3	0.4
90-95	**21,420**	-5.7	-10.9	-2.5	-4.8	-1.0	-1.8	-0.7	-1.0
95-99	**27,560**	-9.5	-17.9	-6.2	-12.1	-1.2	-2.2	-2.5	-4.4
Top 1 Percent	**46,314**	-7.8	-14.8	-4.7	-9.3	-0.8	-1.4	-1.5	-2.7
Memo: Revenue Effect ($ billions)		***9.7***	***10.4***	***9.4***	***10.4***	***10.5***	***10.4***	***11.0***	***10.4***
Memo: Total Change in Contributions ($ billions)		***-6.0***	***-10.8***	***-5.0***	***-9.8***	***-1.4***	***-2.4***	***0.0***	***0.0***

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-2).

Figure 4



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-2).

Of the $10 billion revenue options shown in these two figures, the "above-the-line" deduction with the 1.7% floor has approximately a neutral effect on giving. The floor reduces giving very modestly, and the extension of a deduction to non-itemizers increases giving by about the same amount. In these examples, the strongest loss in giving comes from replacing the deduction with a refundable 15.25% credit. This option leads to about the same revenue gain but a decline in giving of 3.0% if givers are less responsive, and a decline of 5.4% for $10.4 billion in revenue if donors are more responsive.

Obviously, these numbers are only projections, not exact representations of the effects of each of these laws; the variation in responsiveness of donors demonstrates this uncertainty. However, what this simulation does reveal is that a floor on the charitable deduction could raise as much revenue as a cap or a credit, while decreasing giving by considerably less. Also, depending on the method of raising revenue, the effects on charitable giving vary greatly.

To compare these options to the 28% cap on itemized deductions proposed in the American Jobs Act: the Urban-Brookings Tax Policy Center Microsimulation Model projects that at 28% cap would decrease contributions by $1.7 billion if donors are less responsive and $3.2 billion if donors are more responsive, although the revenue pick up is only $3.1 billion in the less responsive case and $3.5 billion in the more responsive case.[2] This option generates less than half of the $10 billion of revenue pick-up shown in the figures.[3]

Note how combining options creates new possibilities. For instance, extending a deduction to non-itemizers might initially be considered poor tax policy since it is believed to cost significant revenues per dollar of charitable pick-up. And it could add significantly to IRS compliance costs. But if combined with a floor on giving, the package could easily be designed to increase both revenue and charitable giving without adding to those IRS costs.

Several other options presented in Figure 2 deserve strong consideration. One way of increasing revenues without losing contributions would be to increase compliance by giving the IRS better tools to monitor charitable deductions, reduce opportunities to overvalue gifts, and remove opportunities for taxpayers to declare deductions for giving that never took place. The net result would be better tax policy, better tax administration, and a stronger charitable sector—and perhaps most important, an intangible: a sector with improved integrity, one that better represents the public it claims to serve.

Some compliance efforts, of course, could place some additional burden on some charities. Still, the net amount for charitable purposes is clearly a far more important consideration than the gross amount flowing through any particular charity. For instance, suppose a provision forces a loss of $100 of contributions, but only $25 of that amount ever really gets to charitable recipients. Intermediaries along the way walk away with the other $75. Suppose additionally that Congress offers charities, as whole, subsidies likely to increase giving to charitable beneficiaries by $30. Then, the net amount of real charitable activity is larger ($30 less $25). Not only is there more money available to ultimate beneficiaries, but the economy as a whole is also now more efficient and wastes fewer resources along the way.

These various revenue pick-up items could be used to support a number of other items that likely would increase charitable giving, such as allowing giving until April 15, relaxing some rules on maximum amounts that can be given away, and reducing and simplifying the excise tax on foundations.

I cannot give you precise estimates for some of the options that I suggest you consider—for instance, allowing people to take deductions on last year's return up to the time of filing their return or increasing compliance efforts. Numbers from the Joint Committee on Taxation would have to be obtained before the exact parameters of a combined package can be determined.

What are some elements of a legislative package that might be considered? Here are some examples:

Some Potential Elements of a Combination Legislative Package

Revenue Increasing But With Minimal Impact on Charitable Giving

1. **Place a floor under charitable contributions so that only amounts in excess of the floor are deductible.** Economists generally believe that some base amounts of contributions would be given regardless of any incentive (e.g., the first $500 for someone giving away $1,000). Two additional trade-offs, however, must be considered. First, a

[2] The baseline contributions in this analysis are slightly different compared to those in Figures 3 and 4, because this simulation excluded dependent tax filers.

[3] This estimate analyzes only the effect of a 28% cap on charitable giving relative to current law, not the potential effect of the American Jobs Act as a whole. Because the estimate does not consider the concurrent impact of other reform proposals, caution must be used in drawing a comparison with the options mentioned in Figures 3 and 4.

percentage floor might be defined relative to some average amount of giving, so that taxpayers might actually respond positively to show that they want to provide at least some average amount. However, a percentage floor does operate as a slight increase in marginal tax rates (e.g., someone in a 28 percent tax bracket might end up paying 28.28 percent on an additional dollar of earnings).

2. **Provide an improved reporting system to taxpayers for charitable contributions.** This would involve expansion of information 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). Further consideration ought to be given to requiring 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.

   For most charities, in truth, the net additional cost would be small because most already have a system in place to keep track of their donors and how much they have given. Even most churches now give taxpayers a statement at the end of the year as to the cash contributions they stick in envelopes. Still, some software would probably need to be developed that would integrate current systems of reporting with any new system of reporting to the IRS, and there would be some transition costs.

   Historically, reporting of Social Security numbers for children or of interest and dividends appears to have led to very high improvements in compliance. Also, a well-developed information system is an important step empowering the IRS in an area where compliance efforts, by being minimal, encourage cheating.

   A viable trade-off here, as well as transition method, might be to require an information reporting system for those charities wanting to opt into the April 15 deduction proposal below.

3. **Limit deductibility for in-kind gifts where the net amount to the charity is so low (because of payments to intermediaries) that the revenue cost to government is greater than the value of the gift made.** Alternatively, at least improve the information that donors receive. For instance, require that the charity must report to the taxpayer on the net amount received after payment to intermediaries, including advertisers, if this amount is less than, say, 50 percent of the value of the gift.

   For household goods alone, Congress ought to consider the Joint Committee option to remove the deduction. Recent IRS data on donations of clothes, for instance, implies some fairly extraordinary amounts of such deductions, and it is well known that many intermediaries operate so that charities often get very little relative to the amount of revenue loss to the government.

   At a minimum, require full and transparent public disclosure by fundraising intermediaries of the amount of the 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 should be publicly available, just like the 990 returns of charities.

4. **To help the public monitor the charitable sector, require electronic filing by most or all charities.** Today, a large confluence of charitable sector groups, researchers, state attorneys general, and private-sector information firms unite in trying to clean up the charitable sector. One step that would help them greatly would be to require the electronic filing of tax forms, such as the 990 and 990 PF, for most or all charities. Electronic filing will (1) improve compliance by charities, (2) lead to better monitoring of the sector by the public, (3) help state attorneys general catch non-tax abuses, and (4)

reduce the paperwork exchange among charities (e.g., by foundations needing information on grantees). It also makes the IRS's job easier, allowing it to devote more resources to compliance efforts that raise revenues. Congressional backing here for electronic filing and for making existing electronic files available as quickly as possible to the public could add to the momentum toward producing a more vibrant nonprofit sector.

Proposals to Enhance Incentives

5. **Allow deductions to be given until April 15 or the filing of a tax return.** This is the same rule that applies to IRAs and Keogh plans. If the tax system is to encourage giving, then the best time to advertise is when people are filling out their tax returns or their tax preparers are looking for additional ways to save them taxes. The long-term cost of this extension would be only a fraction of whatever increase in charitable giving might result since there is almost no cost unless giving goes up. Therefore, it would be one of the most effective measures that could be adopted in terms of induced charitable giving per dollar of revenue cost.

   To deal with some enforcement issues, however, this April 15 allowance might be allowed only for contributions accompanied by an improved reporting system, as is the case with IRA contributions. Otherwise, Treasury fears that some taxpayers would take the deduction twice, on April 15 of the year of deduction and then when filing the tax return for the next year. With IRAs, the issue is solved by the recipient charity working with the taxpayer to provide a 1099 indicating the year to which the deduction applies.

6. **Adopt a deduction that is the same for non-itemizers and itemizers alike.** Charitable bills in the past often offered an extension of deductions to non-itemizers, but generally failed to deal with either the costs per dollar of pick up or with increased IRS enforcement problems. Combining a new deduction with a floor can neatly solve both problems. For some complicated but very important reasons, it is crucial that any resulting deduction and floor be the same for itemizers and non-itemizers alike.

7. **Consider proposals to place less strict limits on charitable contributions, such as the proposal to allow contributions to be made from individual retirement accounts (IRAs) and allowing lottery winnings to be given to charity without facing tax.** Various versions of this proposal would allow money to be paid directly out of IRA accounts without having to be declared first as income subject to tax and then deducted. I have suggested that lottery winners ought to be given a brief period when they can give away as much as 100 percent of their winnings in the same manner. (Right now they are penalized for not engaging in a legal commitment to share their lottery winnings at the time the ticket is purchased but before they have won—an almost impossible condition given the odds of winning and the cost of such a legal transaction relative to the cost of a ticket.)

   The simplification aspects of these proposals almost surely would increase charitable giving and would likely lead both mutual funds and state lotteries to advertise the availability of these options. Whatever rule is adopted, there should be at least one line on the individual tax return reporting gifts made in any exceptional way, as well as a box on the 1099 sent to taxpayers and the IRS by retirement plans. Only in that way will the IRS and Congress be able to monitor well exactly what is happening over time. This selective approach does grant some individuals an exception to the limit on giving of 50 percent of adjusted gross income, an issue that must be admitted. On net, however, I believe that the simplification gains would enhance giving enough to make the proposal worthwhile.

8. **Raise and simplify the various limits on charitable contributions that can be made as a percentage of income.** There seems to be no significant reason for limiting corporate giving to 10 percent of income. For moderate- and middle-income individual taxpayers, in addition, one could consider removing the various individual limits (50 percent for all giving, lesser amounts for giving to foundations and for giving appreciated property). The goal here is both to simplify and to enhance charitable giving. The limit on giving to foundations ought simply to be folded into whatever overall limit applies to giving in general; this separate limit for foundations has a tortuous history that has little to do with the present circumstances of foundations.

9. **Reduce and dramatically simplify the excise tax on foundations.** Whatever Congress gives back here will automatically be paid out to the public in the form of greater charitable activity—thus meeting the primary test for effectiveness outlined above. This tax also raises far more than is needed to meet its intended Congressional purpose—to support IRS costs of monitoring the nonprofit sector. The current design discourages payouts today because they can increase future excise taxes (which are higher when giving tomorrow does not exceed giving today).

10. **Change the foundation payout rule so that it does not encourage giving in a pro-cyclical manner.** Stock market bubbles can cause grants to rise dramatically for a few years, but then a later recession and a bursting bubble tends to lead at least some foundations to reduce grants. It is counterproductive to require private foundations to pay out more money when times are good and to induce them to pay out less when times are bad. For instance, those foundations that kept up giving during the recent Great Recession will soon be penalized with a higher excise tax. Revisions to the payout formula that would reduce this pro-cyclical effect need to be considered. Whether the average rate of payout needs to be lower over time is a separate issue and is discussed in item 9, above.

In many cases, charities that might be reluctant to take on some of these suggested limits or reporting requirements, considered in isolation, would find that they are much better off with the broader legislative package than without it. For instance, a floor under itemized deductions would have little effect on itemizers since it would have little effect on their marginal giving, but it would increase the amount of revenues that could be spent on expanding the deduction to non-itemizers. The additional reporting requirements make it easier to allow giving until April 15, which likely would increase giving significantly because it markets the tax incentive at the time the tax return is filed.

Conclusion

As I have indicated, I believe we are I the midst of a radical fiscal turning, one that is going to require us to look through a whole slew of spending and tax subsidy programs and decide which ones to keep, which ones to get rid of, and, in many cases, how best to pursue objectives that Congress decides remain worthwhile for the government to undertake. I have tried to show that in the case of tax law toward charitable contributions, there is a lot we can do to make our subsidy system more effective from both a fiscal and a charitable sector standpoint.

Here, then, is an ideal trade-off. The monies derived from a floor under charitable giving, several improved compliance measures, greater restrictions on non-cash gifts where abuse is likely or enforcement is next-to-none, and a better system of information reporting could be spent to enhance charitable incentives: allowing taxpayers to benefit immediately from the charitable contributions they make while filing their tax returns, extending the deduction to more taxpayers who don't itemize, raising the ceiling on allowed charitable giving for some types of gifts, and fixing the foundation excise tax that has been under consideration for some time.