

Tax Reform and Charitable Contributions

Statement of

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Any opinions expressed herein are solely the author’s and should not be attributed to any of the organizations with which he is associated.

Mr. Chairman and members of the Committee:

It is an honor once again to testify before you, this time on the relationship between tax reform and charitable contributions.

My testimony will center largely upon one point: that a tax subsidy like that for charitable contributions should be treated like any other government program, examined regularly, and reformed to make it more effective.

The good news is that the charitable deduction can be designed to strengthen the charitable sector and increase charitable giving at the same or even lower revenue cost.

What's the trick? Simply put, take the revenues that are spent with little or no effect on charitable giving, and reallocate some or all of them toward measures that would encourage giving more effectively.

For example, to increase giving, Congress can

- create a charitable contribution for all taxpayers, not just itemizers;
- allow people to make contributions until the filing of their tax return or April 15;
- make it easier for people to donate from accumulated amounts, such as retirement accounts and lottery winnings; and
- remove or reduce (and certainly simplify (the dysfunctional excise tax on foundations.

Congress can more than pay for these changes with little or no reduction in giving if it would

- put a floor under deductions, which would have little effect on giving incentives;
- reform subsidies that tend to be highly ineffective and invite abuse, such as the deduction for household goods and clothing (where problems are likely more egregious than with the automobile deduction, which Congress recently reformed); and
- provide a better information system for charitable gifts.

Certainly expanding the deduction to nonitemizers almost requires some offset like a floor for administrative reasons. The IRS does not and cannot properly enforce the rules for many charitable contributions already.

It would be much easier for Congress reform the charitable deduction if the Committee were to request the assistance of

- the Joint Committee on Taxation and Treasury to provide estimates of the effect on giving, not just revenues, for alternative proposals affecting the charitable sector;
- the IRS to develop better methods for informing Congress, through audits and related follow-through, of the extent to which deductions for certain types of gifts were legitimate, not legitimate, or unable to be verified one way or the other.

This approach to tax reform and charities is very different from one that derives from across-the-board cuts or caps, which tend to operate like sequestration. Certainly, some subsidies should be capped, as they are most ineffective at the margin or for the last dollar of subsidy given. Examples here include subsidies for homeownership or health insurance, where we mainly want to subsidize the first dollars of spending rather than for second homes or the last dollars spent on McMansions or expensive health insurance. Just the opposite applies to

charitable giving, where the last, not first, dollars given are the ones best subsidized and the ones most likely to be effective in generating additional public goods.

The remainder of my testimony will elaborate on these points.

The Budget, Taxes, and Charities

Almost every person and institution must 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. They are unavoidable tasks in which all of us must engage.

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 apart.

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: business, household, and nonprofit.

These responsibilities form part and parcel of the same goal.

In most of my testimony, I compare various proposals according to their effect on charitable giving and revenues. A charitable incentive, however, provides benefits 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. It promotes a general spirit of giving and the development of mediating institutions.

Promotion of charity also provides one way for a capitalistic society to reduce 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 also to the behavior of the donors.

Finally, in assessing the burdens that each of us must accept to get the budget into order, we must be careful how we assess changes in charitable incentives. If the taxpayer responds to a dollar less incentive with a dollar (or 50 cents) less giving, then those who would have benefited from the donation—the museum visitor, the food bank recipient, the student—bear a significant share of that particular burden change.

Reforming Charitable Incentives

Let me now lay out for you how a detailed reform of charitable tax law might be pulled together to achieve several of your longer-term objectives more effectively than the shortcut method of grabbing items off a laundry list or applying a sequester-like cap on all sorts of tax subsidies. As I noted, it is quite possible to undertake reform that both cuts back on the cost of the charitable deduction and raises revenues.

I discuss different tax options by how much they increase giving per dollar of revenue loss. 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), can 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 lose 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 more sensitive to tax incentives.

I would like to have included various compliance efforts or limitations on various types of charitable gifts in the table, but I had less information on their impact. My belief is that many current practices yield very little charitable giving per dollar of revenue loss.

Figure 1 shows you the estimated impact of three 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; the Urban–Brookings Tax Policy Center presents results using two differing assumptions about the responsiveness of donors to the charitable deduction that have been used by such agencies as the Congressional Budget Office.¹

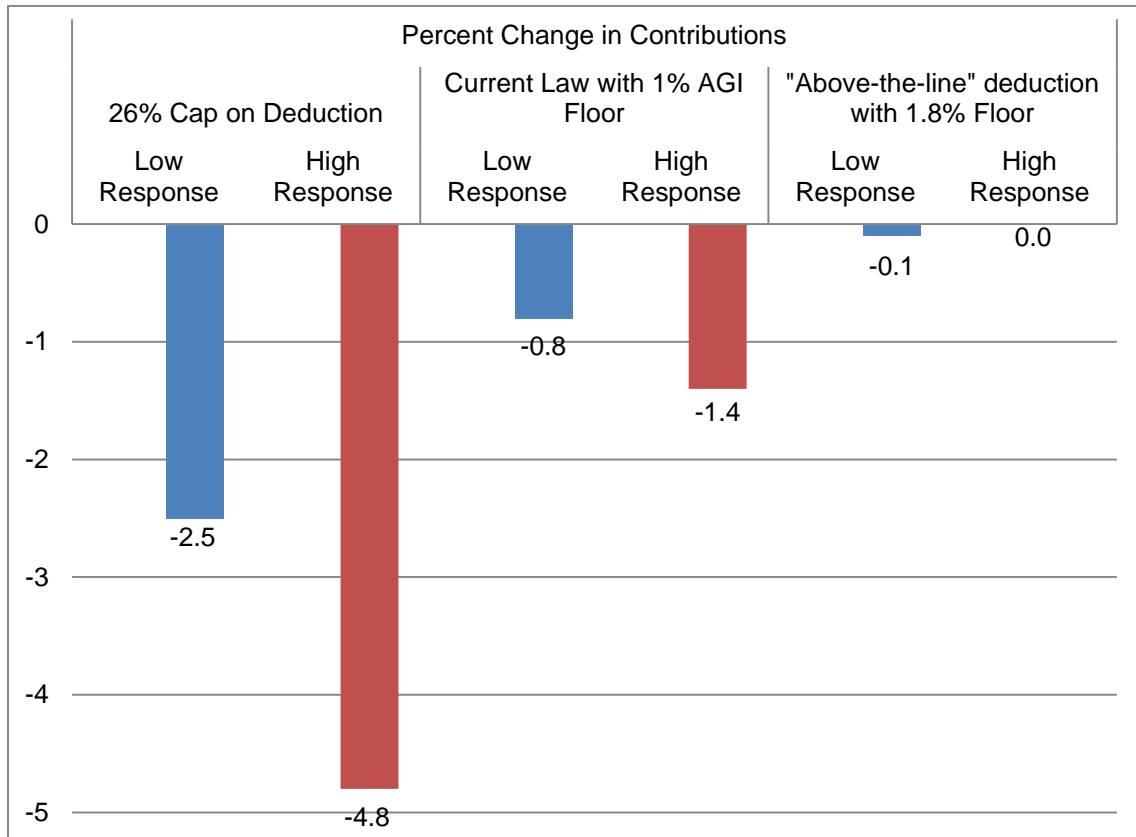
Of the \$10 billion revenue options shown in the below figure, the “above-the-line” deduction with the 1.8% floor has approximately a neutral effect on giving. The floor reduces giving very modestly, and the extension of a deduction to non-itemizers increases giving by about the same amount. In these examples, the strongest loss in giving comes from capping the deduction at 26 percent. This option leads to about the same revenue gain but a decline in giving of 2.5% if givers are less responsive, and a decline of 4.8% if donors are more responsive.

Obviously, these numbers are only estimates, not exact representations of the effects of each law change; the variation in responsiveness of donors demonstrates this uncertainty. However, what these simulations do reveal is that a floor on the charitable deduction could increase giving substantially with no loss or even a gain in revenues.

Note how combining options creates new possibilities. For instance, extending a deduction to non-itemizers might initially be considered to cost too much per dollar of charitable giving and to 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.

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 1. Impact on Charitable Giving of Options to Change the Charitable Deduction
(with roughly \$10 billion in revenue increases)
2011**



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

Several other options deserve strong consideration. Allowing donors to deduct gifts until the filing of a tax return, or April 15, would produce very large bang per buck. Roughly speaking, each dollar of additional giving would cost only 20 to 40 cents (essentially the taxpayer's tax rate times \$1). Another 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.

In considering limitations, Congress must also consider how much net benefit ultimately reaches the intended charity, as it did when it addressed some of the abuses with automobile deductions. For instance, suppose a provision forces a loss of \$100 of contributions, but only \$25 of that amount ever really gets to charitable recipients. Many clothing and household good contributions, even when fairly reported despite an all-around lack of enforcement, fall into this category. Intermediaries in this example walk away with the other \$75.

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.

Here then is a more detailed summary of the elements of a legislative package that could be considered in designing charitable tax reform.

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 only amounts higher than 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). A floor reduces the revenue loss associated with the giving that would occur in the absence of a deduction, while preserving the tax incentive on the portion of giving that is most sensitive. If a percentage (of income) floor might be defined relative to some average amount of giving, then 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 facing a 1 percent floor might end up paying 28.28 percent on an additional dollar of earnings). A floor also might encourage taxpayers to “bunch” their gifts over time to maximize the tax benefit.
2. **Provide an improved reporting system to taxpayers for charitable contributions.** This would involve expanded 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 track their donors and how much they have given. Even most churches now give taxpayers a statement at the end of the year of 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 Social Security numbers for children and reporting interest and dividends appears to have led to very high improvements in compliance. Also, a well-developed information system is an important step to empowering the IRS in an area where compliance efforts, by being minimal, encourage cheating.

A viable trade-off here, as well as a 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, 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 value donations of clothes and household items at \$11.6 billion in 2010, the largest category after corporate stock.² These are fairly extraordinary amounts, and it is well known that many intermediaries operate so charities often get very little relative to the amount of revenue loss to the government.

An example of effective IRS enforcement of noncash charitable contributions occurred in 2003 when GAO released a study finding suspiciously large unsubstantiated deductions for donations of vehicles to charity. In response to evidence that donors were claiming well in excess of the value of these deductions to charities, Congress in 2004 limited the deduction for vehicles worth over \$500 to the charity's actual selling price of the vehicles. Total tax deductions claimed for vehicles fell from \$2.3 billion in 2003 to \$0.4 billion in 2010. It may be time for a similar assessment of donations of clothing and household items.³

At a minimum, require full and transparent public disclosure by fundraising intermediaries of the amount 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.

Enhancing 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

² Prepared by Gerald Auten, Office of Tax Analysis, United States Department of the Treasury, September 2012. Source: SOI Bulletin, various issues, and irs.gov/taxstats.

³ C. Eugene Steuerle, "Cutting Back on Charitable Incentives: The Case for Automobiles," *The Government We Deserve*, November 30, 2012.

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 pickup 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 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. The current IRA rollover can only be used by taxpayers age 70½ and older, and annual contributions are limited to \$100,000. These rules could be expanded to allow more people to donate money from their IRAs to charity. 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 it does not encourage giving pro-cyclically.** 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.

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 barely influence 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

Budget and tax reform are now unavoidably intertwined. Even if they weren't, it is long past the time when we started to examine each tax subsidy rigorously on a periodic basis and to reform it to be more effective. I have tried to show that in the case of tax law toward charitable contributions, we can do a lot 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 noncash gifts where abuse is likely or enforcement is next to nonexistent, 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 if not eliminating the foundation excise tax.