

PRESIDENT BUSH'S PROPOSAL TO ENCOURAGE CHARITABLE GIVING

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Mr. Chairman and members of the Committee:

Debate over tax policy is always intense, as it should be since much of the government's agenda is defined within the tax system. When it comes to tax cuts, this debate usually centers on size of government and progressivity of the tax system. However worthy this focus, it often takes too much attention away from such traditional tax and budget policy principles as equal justice or equal treatment of those in a similar situation, efficiency, simplicity, ease of administration, and transparency — what I will here call the effectiveness principles.

I am especially thankful that these hearings make room for discussion of these principles, whether the subject be child credits or marriage penalties or rate reduction. Tax treatment of the charitable sector — today's hearing — is a perfect example of a discussion where these more traditional policy principles come to the fore. The basic question that you ask your witnesses is how can tax provisions affecting charities and other nonprofit organizations be revised to be made more effective?

The issues on the table today are truly nonpartisan in nature, and I know of no significant differences between the major political parties in what they hope to achieve. The President, along with many other Republicans and Democrats, have put forward a number of suggestions aimed at strengthening the nonprofit sector of the economy. The goodness of a society is defined by the sum total of what all its members do, whether directly as individuals, as contributors of time and money to others, as participants in community activities, or as taxpayers and representatives. The government can't do it all and neither can charities. In such a dynamic world, the government's relationship to the nonprofit sector needs periodic examination and review. It is my hope that this Committee and the Congress will consider the President's proposals as a base but then build upon and reform that base with policy principles in mind.

The President's proposals all have as a primary purpose a further encouragement of charitable giving. Thus, following his lead, a primary (but not only) test that this Committee should adopt is how much different alternatives expand giving relative to the revenue cost involved. In addition to commenting on the President's proposals, therefore, I will additionally discuss some closely related proposals that I believe would be as effective or even more effective in enhancing charitable activity.

Table 1

**PRESIDENT BUSH'S PROPOSALS TO ENCOURAGE
CHARITABLE GIVING**

- **Granting a Charitable Deduction for Non-Itemizers**
The Federal charitable deduction will be expanded to taxpayers who do not itemize and thus currently cannot claim this benefit.
 - **Permit Charitable Contributions from IRAs Without Penalty**
Under current law, withdrawals from Individual Retirement Accounts are subject to income tax. President Bush supports legislation that would permit individuals over the age of 59 to contribute IRA funds to charities without having to pay income tax on their gifts.
 - **Raise the Cap on Corporate Charitable Deductions**
Corporations would be permitted to deduct charitable donations until their value exceeds 15 percent of the company's taxable income, instead of the 10 percent limit under current law.
 - **Promote a Charitable State Tax Credit**
States would be encouraged to provide a credit (of up to 50 percent of the first \$500 for individuals and \$1,000 for married couples and corporations) against state income or other taxes for contributions to charities addressing poverty and its impact. States would be given the flexibility to offset the costs of a charitable state tax credit by using money from the Temporary Assistance to Needy Families (TANF) program.
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Adopt a deduction that is the same for non-itemizers and itemizers alike. The President currently suggests adopting a deduction for non-itemizers, but the Administration has not suggested that a floor would be required. (A floor provides a base under which deductions would not be allowed.) For some complicated but very important reasons, I believe that it is crucial to adopt a floor and that this floor be the same for itemizers and non-itemizers alike. The goal is to expand the potential availability of a deduction to all taxpayers, but in a way that most clearly increases giving per dollar of revenue cost but does not add significantly to taxpayer and IRS administrative and compliance costs. Here, roughly speaking, is the logic that leads me to support a common floor:

Step One: IRS cannot accurately monitor small amounts of contributions. With elimination of the standard deduction, this implies that the Congress — either this year or in the future — would likely consider putting some floor under contributions before they would be deductible to non-itemizers. Fortunately, a floor significantly increases the amount of giving relative to the revenue cost.¹ With a floor, the incentive is more likely to be confined to extra giving rather than that giving that would take place no matter what the incentive. For someone giving away over \$200 already, a contributions' deduction on the first \$200 provides almost no incentive.

Step Two. Creation of a different floor for non-itemizers than for itemizers would create a large amount of taxpayer confusion.² Deductions would pop up in two different places on the tax return, and the decision over which place was optimal would require a number of calculations. One could no longer add up itemizable deductions and compare them to the standard deduction, but, instead, one would have to compare remaining itemizable deductions plus charitable gifts with no floor to itemized deductions excluding charitable gifts plus charitable gifts less a floor. In addition, for some taxpayers, issues such as the phase-out of itemized deductions would affect where it was optimal to deduct.

Step Three. A common floor for itemizers and non-itemizers removes this complexity. It also encourages a greater level of giving per dollar of revenue cost. For instance, a \$150 floor under all taxpayers would likely raise more charitable gifts than a revenue-neutral floor — say, \$400 — under non-itemizers alone.

Step Four. In patchwork tax reduction bills, the pretense often is that every provision only grants benefits to taxpayers. A small floor extended to itemizers by itself raises taxes for some taxpayers even though for almost all of them rate reduction and child credits would more than offset this minor decrease in tax benefits. Moreover, the costs of not adopting a common floor are not trivial: taxpayer reaction against a more confusing tax return and charitable contributors reaction against the increase in cheating that would arise.

¹ See Cordes, et al. (attached)

² See Steuerle, 2000a and 2000b.

Stop phasing out itemized deductions of charitable contributions. Although this reform technically is not part of the President's proposal to have a non-itemizer deduction, it would fall out almost automatically if a common floor (including no floor) on itemizers and non-itemizers were adopted. Everyone would take their deductions somewhere other than on the itemized deduction schedule, so that folding these deductions back into the phase-out would be complicated and appear somewhat silly. The current rule most penalizes those who give away a great deal and it is mainly a backdoor tax rate increase. It should be abandoned.

Consider proposals to remove limits on charitable contributions, such as the President's IRA proposal. The President has suggested allowing money to be paid directly out of IRA accounts without having to be declared first as income subject to tax and then deducted. I myself 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 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 types of 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 the Congress be able to monitor well exactly what is happening here over time.

This selective approach, however, does raise some unresolved issues. One is when to allow such exceptions and when not to allow them. For example, if IRA withdrawals are allowed, why not also apply the same treatment to 401(k) plans, stock bonus plans, and other retirement vehicles? Another is that giving out of an IRA would have a different effect on the measure of adjusted gross income (AGI) than would other charitable contributions. Since many other provisions in the Tax Code are tied to AGI, this could complicate planning. On the other hand, giving out of an IRA might be much easier to manage than more complicated charitable trusts, since a taxpayer could simply designate some percentage of annual withdrawals to go to charity.

Raise and simplify the various limits on charitable contributions that can be made as a percentage of income, such as the President's proposal for corporate contributions. 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 to both simplify and 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 present circumstances of foundation.

Begin studies now on proposals to allow credits for contributions to organizations that serve the poor. The President's proposal really is a welfare rather than tax proposal and could be revised by the time that welfare or TANF bills come along. The proposal allows states to spend TANF money on charitable credits serving low-income individuals. It attempts to address worthy goals — encouraging giving to charities serving the poor and using a “market-like” test of individual contributions to see where some government subsidy ought to be provided.

To be sure, a number of difficult details need to be worked out: how to certify eligible charities; how taxpayers can identify eligible charities; whether one type of charity should be favored over another in the tax system; whether the particular caps suggested would tend to reduce, rather than increase, the net amount of funds available to the poor; how much of the charitable incentive would simply encourage givers to switch from one type of charity to another; and whether funds allocated through this type of “market test” would be too confined to particular segments of poor individuals who happened to live near the charities involved.

There may be ways to get around some of these problems, and it is not clear that this needs to be a tax rather than spending provision. For instance, states could be encouraged to pass through assistance dollars to charities that both certify higher levels of individual contributions for helping the poor and are open to serving broad segments of the poor. In any case, study should begin now rather than waiting until the welfare bills come up and it's too late to craft alternatives efficiently.

In addition to these refined versions of the President's proposals, I very much hope that you will also consider a number of other related alternatives.

Allow deductions to be given until April 15 or the filing of a tax return. This is the same rule that applies to Individual Retirement and Keogh plans. Imagine a company deciding to advertise a sale except when the purchase was taking place. 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 preparer is 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 where there is some paper back-up, as is done with IRA contributions.

Reduce and dramatically simplify the excise tax on foundations. This tax 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).³ Moreover, whatever Congress gives back here will automatically be paid out the public in the form of greater charitable activity — thus meeting the primary test for effectiveness outlined above.

Devote more IRS resources to helping the public monitor the charitable sector. The exempt organization function traditionally has been treated as an unwanted step-child of the IRS because it brings in almost no revenue. (As noted, moreover, only a fraction of the foundation tax is actually spent by the IRS monitoring the nonprofit sector). Today, however, there is an unusual opportunity that derives from a large confluence of charitable sector groups, researchers, states attorneys general, and private sector information firms who are united in trying to allow electronic filing of tax forms, such as the 990 and 990 PF. They believe electronic filing will: (1) improve compliance by charities; (2) lead to better monitoring of the sector by the public; (3) help states attorneys general catch non-tax abuses; and (4) make it easier to make charitable donations over the Web and to reduce the paperwork exchange among charities (e.g., by foundations needing information on grantees). It also makes the IRS' job easier. Although the IRS is trying to help, it is hampered by the lack of resources. Congressional backing here — even if only a statement of Congressional intent — could add to the momentum toward producing a more vibrant nonprofit sector.

Change the foundation payout rule so that it does not encourage giving in a pro-cyclical manner. Whether the average rate of payout needs to be higher or lower over time is not the issue here. Rather, just as the stock market bubble caused grants to rise dramatically over the past few years, a recession and a bursting bubble now make it very possible that these grants will fall dramatically. If so, foundation grant-making would drop when it is needed the most. Revisions to this formula that would reduce this pro-cyclical effect need to be considered.

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In summary, the tax system can be reformed in a way that adheres to fundamental principles of tax and budget policy. The thrust of my suggestions here is to maximize the amount of charitable giving in society for whatever revenue cost the Congress picks. My suggestions also try to minimize or reduce tax filing costs for taxpayers and deal with legitimate concerns about tax compliance and enforcement. Finally, I hope that this Committee will give these types of proposals priority in the tax bill: compared with one dollar of simple tax reduction, one dollar spent on many of these proposals has the *added* benefit of increasing charitable giving or grantmaking.

³ See Steuerle and Sullivan.

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