



Joint Committee on Taxation
April 5, 2005
JCX-14-05 R

**TESTIMONY OF GEORGE K. YIN
CHIEF OF STAFF
OF THE
JOINT COMMITTEE ON TAXATION**

**AT A HEARING OF THE SENATE COMMITTEE ON FINANCE
RELATING TO “CHARITIES AND CHARITABLE GIVING:
PROPOSALS FOR REFORM”**

April 5, 2005

Mr. Chairman, Ranking Member Baucus, members of the Committee, I am pleased to testify today about the exempt organization proposals in the recent Joint Committee on Taxation staff report on “Options to Improve Tax Compliance and Reform Tax Expenditures.”¹ As you know, the report was in response to a request of the Chairman and Ranking Member.

In the report, the staff offered a range of proposals to address many potential causes of noncompliance in the tax system. In my testimony today, I will describe only the proposals involving the tax-exempt sector, particularly the charitable sector. I will first discuss proposals dealing with charitable contributions and then turn to those concerning the operation of exempt organizations.

Noncompliance in Charitable Contributions

In the case of charitable contributions, the report focuses on the most significant area of potential noncompliance, namely the valuation of noncash charitable contributions.

Under present law, taxpayers are entitled to deduct the fair market value of most charitable contributions of capital gain property to a public charity. When property value is uncertain, this rule presents compliance burdens for the taxpayer, noncompliance opportunities, and law enforcement difficulties. Challenging taxpayer valuations is a very resource-intensive task for the IRS. Even a preliminary determination that the amount of a deduction may be

¹ Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005.

questionable requires an upfront commitment of resources. If a serious challenge is to be made, more resources are needed to secure alternate appraisals and expert opinions. The less likely the threat of enforcement, the more likely is the possibility of overvaluation and noncompliance. Adding to the problem is the fact that the interests of the donor and donee are generally aligned because each wants to see the gift completed. Thus, each party has a reason to give the value claimed by the donor the benefit of the doubt.

The staff report contains several options intended to improve compliance for charitable contributions of property. The report does not propose changing the current law rules with respect to cash gifts or gifts of publicly traded securities, which do not present valuation concerns.

General treatment of contributions of appreciated property

First, in general, for contributions of appreciated property, the report proposes that the charitable deduction be equal to the taxpayer's basis in the property. This is the present-law rule for contributions to most private foundations as well as contributions of certain property to public charities. In most cases, basis is a more certain amount than fair market value and subject to easier proof by the taxpayer and verification by the IRS. Thus, this option could be expected to improve compliance, reduce burdens and disputes, and lessen the amount of IRS enforcement effort. It would also eliminate the greater tax preference under current law provided to these types of property gifts than to contributions of cash.

As an alternative, the report suggests that a basis deduction might apply only to taxpayers contributing property unrelated to the charity's exempt function. Under this alternative, for example, a taxpayer could still deduct the fair market value of an appreciated gemstone given to a natural history museum, but could deduct only the basis of appreciated closely held company stock or real estate contributed to the museum.

Used clothing and household items

The general treatment of gifts of property just discussed would not be helpful for gifts that have depreciated in value, such as used clothing and household items. In such cases, the deduction is limited to the value of the property. Thus, a determination of value is still necessary.

Congress faced this same challenge last year in adopting rules for the donation of vehicles. Before the new rules, vehicles, like clothing and household items, were deductible at their fair market value at the time of the gift. Under the new rules, a taxpayer generally is not allowed any deduction for a contribution of a vehicle until the item is sold by the charity, at which point the sales price provides an indication of the proper amount of deduction. However, this solution obviously would not be feasible for the many thousands of items of used clothing and other household goods given to charities each year.

The relatively small value of any item of clothing or household goods makes it unlikely that the IRS challenges many of these deductions, leaving taxpayers with significant flexibility in valuing such gifts. Moreover, taxpayers may have a natural tendency to overvalue such items due to the attachment they have to the item.

Because this situation is vulnerable to error and noncompliance, the report proposes that at a minimum, the potential amount of error should be capped. Thus, the report suggests limiting the deduction for gifts of clothing and household goods to \$500. This option has sometimes been mischaracterized as granting taxpayers an automatic \$500 deduction with no questions asked. In fact, all of the current-law substantiation requirements would continue to apply in order for the deduction to be available; the proposal simply limits the deduction to no more than \$500 each year.

Conservation easements

Unlike clothing and household items, the value of a conservation easement generally exceeds the taxpayer's basis in the easement. Yet a rule limiting the charitable deduction to the taxpayer's basis in the easement is of no help in easing the potential noncompliance problem because in most cases, the taxpayer's basis in the easement will depend upon a determination of the fair market value of the property interest. Thus, if a deduction is to be allowed for conservation easements, a determination of value is again necessary.

For several reasons, determining the value of conservation easements may be even more difficult than in the general case. First, the value of the interest given away is a function of the contract terms crafted by the donor, and will vary from case to case. There may be few, if any, comparables to help determine value. Second, conservation easements constitute only a partial interest in the property rights held by the taxpayer. As difficult as it may be to determine if I have correctly valued the old shirt I give to a charity, at least the charity owns it and I do not. How much more difficult would the value determination be if I retained substantial rights to the shirt after contributing it to the charity? Third, in many cases, taxpayers who make these contributions are already subject to significant State and local restrictions on the use of their property. Such restrictions vary considerably from jurisdiction to jurisdiction and would have to be taken into account in valuing the easement.

Because these valuation difficulties present the greatest challenge in the case of conservation easements placed on property used by the taxpayer as a personal residence, the report proposes that no deduction be allowed for such contributions. For gifts of easements placed on other historic structures, the report proposes a deduction equal to the lesser of 5 percent of the fair market value of the structure or 33 percent of the value of the easement. For all other gifts of conservation easements, the deduction would be limited to 33 percent of the value of the easement. Moreover, the gift must be pursuant to some clearly articulated Federal, State, or local government policy in favor of the conservation objective. The report also proposes heightened appraisal standards and requirements in the case of these contributions.

Noncompliance in Exempt Organization Operations

The second broad category of noncompliance in the exempt organization area is in the operation of the organization. An organization that is granted exemption from Federal income tax warrants exemption not as a matter of right but as one of privilege. To maintain exemption on an ongoing basis, organizations are required always to conduct their operations in a manner that is consistent with the basis for exemption. To the extent an organization deviates from its mission, there is noncompliance.

Five-year review

Under present law, charitable organizations are required to obtain a determination from the IRS that they are tax exempt as a charitable organization, and thus eligible to receive deductible contributions. Typically, organizations apply for charitable status shortly after they are formed and the IRS generally must make its determination of such status based on statements of intent by the organization. However, once charitable status is granted, it rarely is revoked. Yet organizations may change and grow significantly over time, sometimes in ways inconsistent with their exemption. There is no mechanism in present law requiring a periodic review of the basis for an organization's charitable status.

The report proposes that every five years, charitable organizations (other than churches) file with the IRS information that would enable the IRS to determine whether the organization continues to be organized and operated exclusively for exempt purposes. The proposal applies to new organizations and organizations receiving charitable status within ten years of enactment of the proposal. The filing would be done electronically, perhaps as a schedule to the current information return, and be made publicly available to encourage improved oversight of the sector by both the public and by State officials. The IRS would not be required to take action or make any determination with respect to a five-year review filing, but would have the discretion to review any filing and could revoke tax-exempt status retroactively or prospectively, as warranted by the facts and circumstances.

As described in more detail in the report, the information to be filed as part of a five-year review filing would include a narrative about the organization's prior, current, and contemplated operations and practices; a description of the prior, current, and contemplated trade or business activities of the organization and whether and how such activities are related to the organization's exempt purposes; a summary of the organization's compensation of management and senior employees for the previous five-year period; a description of related party transactions over the previous five-year period; a description of the organization's material changes during the prior five-year period; and such additional information as the IRS may require. Private nonoperating foundations would be required to show how much of the foundation's required payout was made up of administrative expenses.

Termination tax on public charities

Related to the issue of an organization's ongoing basis for tax exemption is the effect of a public charity's dissolution, acquisition by a for-profit company, and other change of ownership or control. Federal tax law requires that upon dissolution, the charitable assets of the organization continue to be dedicated to charitable purposes. Yet there is no Federal enforcement mechanism of this requirement in the case of public charities. In contrast, upon their termination, private foundations generally are subject to a tax equal to the amount of the aggregate tax benefit received by the foundation over time (not to exceed the net asset value of the foundation), unless their assets are dedicated to charitable purposes.

As an example of this issue, a charitable nonprofit hospital may be acquired by a for-profit hospital, thus terminating the nonprofit hospital's charitable status. In this case, the "dedication to charity" requirement of present law means that the Federal government has an

interest in ensuring that a fair price is paid for the nonprofit hospital, and that the proceeds from the transaction be dedicated to charitable purposes.

In order to provide the Federal government with a means to enforce the “dedication to charity” requirement, the report proposes a termination tax on liquidations or conversions of a public charity. The tax would also apply to private foundation terminations, and differs from the present law termination tax principally in that the tax would be based on the net asset value of the charity and not on the aggregate tax benefit. The tax could not be recovered against assets held by the charity for charitable purposes. The proposal also would impose the present-law excess benefit transaction rules to conversions of a public charity if, after the conversion, insiders of the public charity are also insiders of the newly converted entity. This is intended to ensure that when insiders are involved in the acquisition of a charitable organization, the acquisition is subject to the present law rules that tax abusive insider transactions.

Exempt organization involvement in tax shelters

One of the primary compliance concerns in tax law today is abusive tax shelters. The increasing involvement of exempt organizations as accommodation parties in tax shelter transactions is a growing concern. Such transactions contribute to the erosion of the tax base by improperly extending the benefit of tax exemption to nonexempt persons. Tax shelters involving exempt organizations also raise questions about whether the facilitation of tax avoidance by an exempt organization can be consistent with the basis for tax exemption. Although recent legislation addressed many tax shelter abuses, such legislation does not prevent certain abuses that might be perpetrated using exempt organizations.

The report provides for an excise tax on the participation by any exempt organization (not just charitable organizations) in a transaction that the Treasury Department determines is a listed transaction, or a reportable transaction that is a confidential transaction or one with contractual protection. Under the proposal, if an exempt organization participates in such a transaction, knowing or with reason to know that the transaction is “prohibited,” the entity is subject to a tax of 100 percent of the entity’s net income attributable to the transaction. If the exempt entity is eligible to receive deductible contributions, the Treasury Department may suspend eligibility for one year. The entity-level tax does not apply to certain pension plans and similar tax-favored accounts. An excise tax would also apply to the entity managers that approved the entity’s participation in the transaction.

The proposal also addresses the case in which an exempt organization participates in a transaction that is later determined by the Treasury Department to be a prohibited tax shelter transaction. Because the exempt entity did not know at the time it entered into the transaction that it would later be prohibited, taxing all of the entity’s net income attributable to the transaction may not be appropriate. However, the proposal would impose an excise tax at the UBIT rate on the exempt organization’s net income from the transaction after it has learned that the transaction is prohibited. There also are obligations to disclose involvement in such transactions.

Other Proposals

I will briefly touch on the other exempt organization proposals in the report.

Private foundation excise tax rates.-- As you know, private foundations are subject to a special set of restrictions and excise taxes that do not apply to public charities. The excise taxes apply to acts of self-dealing, failure to meet the mandated payout, excess business holdings, jeopardizing business investments, and taxable expenditures. The tax rates on the initial taxes have not been revisited since their enactment in 1969. The report proposes a doubling of the present law initial rates of tax.

Intermediate sanctions.-- Public charities are subject to excise taxes on so-called “excess benefit transactions” between the organization and an insider of the organization. This regime was enacted to provide a sanction short of revocation of exemption for abusive self-dealing transactions by public charities. The report concludes that the sanction would be more effective if certain changes are made. For example, present law provides organization insiders with a presumption that a transaction is reasonable if certain steps are taken. The report recommends eliminating the presumption of reasonableness because it unnecessarily gives the taxpayer a procedural advantage on a matter that already is difficult to enforce. The report also suggests modifying the “initial contract exception” so that the sanctions apply to a contract by an organization with a person who is contracting for a position of substantial influence within the organization.

Form 990-T.-- The report suggests that the Form 990-T, which exempt organizations file to report unrelated business taxable income, be made public, so as to provide the public with a better picture of an organization’s business activities. The report also proposes that large exempt organizations obtain a certification from an independent auditor or counsel regarding the organization’s reporting of the unrelated business income tax.

Other proposals.-- The report contains proposals that (1) require small charitable organizations to file short annual returns, (2) expand the base of the tax on the net investment income of private foundations, (3) limit the tax-exempt status of fraternal beneficiary societies that provide commercial type insurance, and (4) establish additional exemption standards for credit counseling organizations.

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We will continue to examine compliance issues in the exempt organizations area and give consideration to possible additional proposals beyond those contained in the report.

Thank you very much for this opportunity to testify.