

Testimony Before the Senate Finance Committee
“Tax Reform Options: Incentives for Charitable Giving”

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Mr. Chairman, Mr. Ranking Member, Members of the Committee, thank you for inviting me to testify before you today about the charitable deduction. Thank you also for holding this hearing. The relationship between government and the nonprofit sector is in need of a critical look, and I commend your ongoing efforts to focus on this issue, among the many others that you face.

As you know, the charitable contribution deduction is a longstanding feature of the federal tax law. Enacted in 1917, four years after the income tax, it has become an embedded part of tax policy and of the landscape for many nonprofit organizations and the giving public. It is also one of the principal tax expenditures. The Joint Committee on Taxation estimates the five-year cost of the tax expenditure as \$246.1 billion.² Of that number \$25.3 billion is for health, \$33.3 billion is for education, and the remaining \$187.5 billion covers other purposes.³

My testimony is intended to provide a framework for thinking about the role of the charitable deduction in the federal income tax. As you decide whether to make changes to the deduction, I think it is important that you consider the following questions. (1) What are the existing characteristics and policy tenets of the charitable deduction? (2) In practical terms, how are the benefits of the charitable deduction allocated? (3) In more theoretical or policy terms, what is the charitable deduction for and is the theory of the deduction consistent with our expectations? And finally, (4) how do existing proposals to change the deduction fit into the current law framework?

A. Existing Structure and Policy Tenets of the Charitable Deduction.

As you know, the charitable deduction is an itemized deduction. As such, it is not used by the roughly 70 percent of taxpayers who claim the standard deduction, many of whom nonetheless make charitable contributions.

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² Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014, Dec. 15, 2010.

³ It should be noted as well that the charitable deduction is but one of several governmental supports for the nonprofit sector. Tax exemption under section 501(c)(3) of the Code and eligibility to receive tax-exempt financing are two other federal tax benefits. In addition, many local and State tax benefits flow from preferred federal tax status, as well as some nontax benefits. A charitable deduction also exists for estate and gift tax purposes.

The charitable deduction is subject to a cap, but the cap is based on a high percentage of adjusted gross income (e.g., 50 percent of AGI for cash gifts to a public charity)⁴ and so does not affect most taxpayers.

The charitable deduction is available for the first dollar of charitable contributions, meaning it is not subject to a floor before the deduction is allowed. As a general matter, the absence of a floor is consistent with some itemized deductions (e.g., the deductions for mortgage interest, and state and local taxes) but unlike others (e.g., the deductions for casualty losses, medical expenses, and miscellaneous itemized deductions).

The charitable deduction generally is allowed at fair market value for contributions of cash or property. Cash gifts present little difficulty, either as a matter of policy or practice (apart from substantiation). The deduction rules for property, however, are complex, difficult to administer, prone to abuse (especially on valuation questions), and allow taxpayers with appreciated assets to avoid taxation on the appreciation.

The charitable deduction requires a qualified organization as a recipient, i.e., gifts to individuals, even if charitable in nature, are not eligible.⁵

The charitable deduction is closely linked to, and generally follows the standards for, tax-exempt status under section 501(c)(3). As a practical and legal matter, this means that two different tax benefits – income tax exemption and eligibility to receive deductible contributions – are subject to the same definitional standard, notwithstanding that the policy basis underlying the two benefits may not be identical. It also means that the scope (and cost) of the benefit for deductible contributions is dependent on the scope of the benefit for tax-exemption. Thus, a broad definition of tax exemption under section 501(c)(3) means a broad pool of organizations eligible to receive deductible contributions.

The definition of a section 501(c)(3) organization is based on an organization's purposes, and is broad. Section 501(c)(3) describes a qualifying organization as one organized and operated for charitable, religious, educational, scientific, and other purposes. The law does not require outcomes or base continuing exemption on quantifiable measures. Typically, organizations apply for section 501(c)(3) status at the outset of existence, secure the status based on promises about the future, and are subsequently evaluated (if at all) for exemption purposes on a vague purpose-based inquiry and not on the effectiveness of the organization.

⁴ The cap is lower for gifts to private foundations (30 percent of AGI) and for gifts of capital gain property (30 percent of AGI if to a public charity, 20 percent of AGI if to a private foundation). Charitable contributions by corporations are subject to a cap roughly equal to 10 percent of the corporation's taxable income.

⁵ Although an organization requirement is sensible, even essential for administrative reasons, it means that government-supported charitable giving is dependent upon the presence of organizations.

The charitable deduction, following section 501(c)(3), generally does not distinguish among qualifying purposes. In other words, all section 501(c)(3) purposes are equally eligible for government support through the charitable deduction.⁶

Although section 501(c)(3) purposes generally are treated equally for charitable deduction purposes, not all section 501(c)(3) organizations are on equal footing. Rather, the charitable deduction disfavors private foundations, and now certain “hybrid” organizations such as donor-advised funds and supporting organizations, relative to other section 501(c)(3) organizations.⁷

Summing up, the charitable deduction is an itemized deduction, with a high cap and no floor, is allowed for contributions of cash and noncash property, disfavors some organizations relative to others (but not on purpose grounds), and relies on standards for tax-exempt status under section 501(c)(3) to define its scope.

B. Who Benefits From the Deduction?

(i) The Section 501(c)(3) sector. Section 501(c)(3) organizations are the main recipients of deductible contributions.⁸ Various referred to as the “nonprofit sector,” the “independent sector,” or the “charitable sector,” none of these names are apt. “Nonprofit sector” is too broad – there are many nonprofit tax-exempt organizations other than section 501(c)(3) organizations. “Independent sector” denotes an independence or separateness from government that is an important trait, but also belies the dependence of the sector on government support. “Charitable sector” is too narrow – section 501(c)(3) confers status on religious, educational, scientific, and other generally noncharitable organizations. Thus, the technical but accurate “section 501(c)(3) sector” is a better label, if only because it forces us to ask more directly what it is we are talking about when we talk about the charitable deduction.

The section 501(c)(3) sector includes over 1.1 million organizations, with revenues of approximately \$1.4 trillion.⁹ The value of assets held by section 501(c)(3)

⁶ That said, the charitable deduction rules do favor certain types of property, for example, food inventory, for use by the donee organization in performance of its exempt function. Exempt-use property as a category also is favored.

⁷ For example, gifts to private foundations are subject to a lower percentage limitation than gifts to public charities. In addition, gifts to donor-advised funds, supporting organizations, and private foundations are not eligible for the special rule allowing tax-free transfers from individual retirement accounts notwithstanding the percentage limitations.

⁸ Other eligible recipients include government entities (if the gift is exclusively for public purposes), certain veterans organizations, fraternal organizations, and cemetery companies.

⁹ Molly F. Sherlock & Jane G. Gravelle, Cong. Research Serv., R40919, An Overview of the Nonprofit and Charitable Sector 3, 9-12 (2009) (reporting as of July 2009). This figure does not include organizations that do not file an exemption application with the IRS, which could number in the hundreds of thousands (e.g., churches, other qualifying religious organizations, and very small organizations). Approximately 116,000 million organizations are private foundations. *Id.* at 9-12. The revenue number does not include organizations that do not report to the IRS on the annual information return (Form 990 series) such as churches and small organizations; \$181 billion is revenue of private foundations.

organizations is approximately \$2.6 trillion.¹⁰ Comparable numbers from the mid-1970s demonstrate the significant recent growth of charities. In 1976, for example, there were 259,523 charitable organizations and in 1975 (using constant 2001 dollars) revenues were approximately \$155 billion and assets were approximately \$361 billion.¹¹ Thus, since the mid-seventies, the section 501(c)(3) sector has grown by about 324 percent in terms of the number of organizations, 918 percent in terms of revenues, and 786 percent in terms of assets. Entire classes of organizations continue to be recognized – churches, hospitals, colleges and universities – though such organizations look much different today than 100 years ago. Indeed, two subsectors, hospitals and colleges and universities, account for over half of the sector’s revenues and assets.¹² The example of hospitals also highlights the ongoing tension within parts of the section 501(c)(3) sector of distinguishing nonprofit and for profit activity.

(ii) Deductible contributions as a source of support. It is important to put the charitable deduction in perspective as a revenue source for the section 501(c)(3) sector. Data indicate that private giving is but one means of support. For example in the year 2005, in the aggregate, section 501(c)(3) organizations relied on deductible contributions for roughly less than nine percent of total support.¹³ Although this aggregate number hides the importance of the deduction to particular organizations, it highlights the fact that as a general matter, deductible contributions are a supplementary source of revenue for most section 501(c)(3) organizations.

Of course, some broad types of section 501(c)(3) organization rely on deductible contributions more than others. For example, data from the same year shows a breakdown of support based on organizational purpose:¹⁴

¹⁰ *Id.* at 11-12 (reporting as of July 2009, not including non-filing organizations). Of this amount, \$621 billion is held by private foundations.

¹¹ Staff of the Joint Committee on Taxation, 109th Cong., Historical Development and Present Law of the Federal Tax Exemption for Charities and Other Tax-Exempt Organizations, 20, 24 (Joint Comm. Print 2005).

¹² Hospitals account for 41.25 percent of revenues and 29.13 percent of assets; colleges and universities account for 11.36 percent of revenues and 21.21 percent of assets. Molly F. Sherlock & Jane G. Gravelle, Cong. Research Serv., R 40919, An Overview of the Nonprofit and Charitable Sector 10 (2009). This is notwithstanding the fact that hospitals are just .65 percent of organizations and colleges and universities just .42 percent of organizations. *Id.*

¹³ *Id.*, Figure 4, 17. The CRS study shows that in 2005 private contributions in the aggregate constituted 12 percent of support. However, private contributions includes not only deductible individual contributions, but also corporate giving, bequests, foundation giving, and gifts by nonitemizers. Given that about 25 percent of all private contributions were from corporate giving, bequests and foundations, support from deductible contributions is closer to 9 percent; and then gifts from nonitemizers should also be taken into account. The aggregate support number does not include private giving to private foundations or to organizations such as churches that are not required to file a Form 990.

¹⁴ *Id.*, Figure 5, 19.

	Private Contributions	Private payment	Government grants/payments	Investment Income	Other revenue
Arts, Culture, Humanities	43%	29%	12%	9%	7%
Education	13%	56%	12%	17%	2%
Environment/Animals	48%	24%	12%	7%	9%
Healthcare	2%	56%	37%	3%	2%
Human Services	16%	41%	36%	3%	4%

Accordingly, hypothetically, if the charitable deduction were eliminated, and if giving as a result significantly decreased, based on this data snapshot, the most adversely affected organization types likely would be those that benefit arts, culture, and humanities, and the environment and animals. Also likely to be most adversely affected are smaller organizations. Such organization types might well find it difficult to find alternative revenue sources and might be forced to curtail programs substantially or to cease operations.

By contrast, the education and healthcare subsectors rely for a majority of support on program service revenue, e.g., tuition, and payments for healthcare, and much less on private contributions. Also noteworthy is that as a class, human services organizations rely more on fees and direct government grants for support than private contributions.

In any event, even in the absence of the deduction, support from private giving would not disappear. Rather, the extent of any reduction in private contributions would depend upon the extent to which donors give because of the tax incentive, or whether donors give without regard to the tax benefit.

In addition, however, although it is important to put the importance of private contributions as a revenue source in the proper context, it is also important not to view private contributions completely in isolation of possible cutbacks to revenue from other sources. Thus, although cuts to the deduction alone might not have an unmanageable impact on finances for many organizations, if deduction changes are combined with cuts to direct government support, this could create the “perfect storm” for many section 501(c)(3) organizations of various types and sizes.

(iii) Distribution of giving and the deduction. Total giving is reported each year by Giving USA and shows how gifts are distributed among organization types. The numbers for 2010 are shown in the following Table:

Religion	\$100.63 billion (35%)
Education	\$41.67 billion (14%)
Foundations	\$33 billion (11%)
Human Services	\$26.49 billion (9%)
Public-society benefit	\$24.24 billion (8%)
Health	\$22.83 billion (8%)
International Affairs	\$15.77 billion (5%)

Arts, culture, and humanities	\$13.28 billion (5%)
Environment/animals	\$6.66 billion (2%)
To individuals	\$4.2 billion (2%)
Unallocated	\$2.12 billion (1%)

The total giving numbers are not limited to individual deductible contributions, however, but include giving by nonitemizers, corporate giving, bequests, and private foundations.

In any event, as an itemized deduction, the charitable contribution deduction is claimed by the more affluent, with the wealthiest generally giving the most. In 2008, for example, taxpayers with adjusted gross income of \$200,000 or more gave 42 percent of deductible contributions and represented just 10 percent of returns. The very wealthiest, taxpayers with AGI of \$10 million or more, gave 11.73 percent of deductible contributions, and were just .03 percent of returns.¹⁵ Charitable contributions at this income level consisted in large part of noncash property – about 50 percent of contributions for this income group and 24 percent of the total noncash property contributions for the year.

The wealthiest of taxpayers fund a variety of organization types. One study of giving by high net worth taxpayers¹⁶ found the following distribution:

Education (27.1 %)
Giving Vehicle (16.5%) (e.g., donor advised fund, trust, foundation)
Religious (14.6%)
Health (10.4%)
Combination Funds (6.8%) (e.g., United Way)
Youth/family (6.3%)
Art (4.2%)
Basic needs/food and shelter (3.7%)
Environment/animal care (2%)
International (1.5%)
Other (6.9%)

As the Table indicates, over half of giving by high net worth taxpayers was for education, private giving vehicles (which may take many years to pay out funds), and health. Organization types receiving less support from high-income givers were those that serve basic needs, the environment and animal care, and international causes.

¹⁵ Tax Policy Center, 2008 Individual Income Tax Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items, by Size of Adjusted Gross Income. Percentage calculations by author.

¹⁶ 2008 Study of High Net Worth Philanthropy, The Center on Philanthropy at Indiana University, March 2009, Figure 14. High Net Worth individuals were defined as survey respondents with household income greater than \$200,000 and/or net worth (excluding the value of their residence) of at least \$1 million.

The above snapshot of the charitable deduction shows that it is designed to be a support of the section 501(c)(3) sector, that it is more important as a source of support to some organizations than to others, and that the giving choices of the more affluent are important dictates of which types of section 501(c)(3) organization benefit.

C. The Purpose of the Charitable Deduction

Given the above as a model, the question becomes one of matching the charitable deduction in practice with the charitable deduction in theory. This of course raises important questions of what the charitable deduction is for. What is it intended to accomplish? What should it be for? There is no single or simple answer.

One place to start is with rhetorical arguments that often accompany discussions about the charitable deduction. For example, a common (and often effective) response to proposals that impinge on the charitable deduction is to stress that this would hurt charity. The argument is often effective because it appears to rely upon an idea of charity that reflects our better instincts – to help those in need. And the argument is accurate, at least to the extent that many section 501(c)(3) organizations do help those in need and rely on the deduction.

Such reflexive support for the charitable deduction raises questions, however, because, as the discussion above should indicate, the charitable deduction supports not “charity” as it is commonly understood, but rather the entire section 501(c)(3) sector, of which basic needs or traditional charitable organizations are just one of many supported types.¹⁷ Thus, to the extent the rhetorical view reflects a traditional idea of charity (it is after all the “charitable deduction” and not the “section 501(c)(3) sector” deduction), then significant change to present law is suggested, namely, by weakening the link between section 501(c)(3) exemption and the charitable deduction and to redefine “charity” for deduction purposes.

There are, however, other explanations for the charitable deduction than the rhetorical view. Broadly speaking, there are two strands of thought. One largely discounted but still important rationale for the deduction is rooted in the definition of income for tax purposes. Under this theory, income simply does not include amounts paid to charity. Charitable expenses are not like other nondeductible personal expenses (i.e., consumption) but rather have a public benefit. Therefore, such amounts should not form a part of the tax base.

The other, and principal, rationale for the deduction is that it is an incentive or subsidy. Again, roughly speaking, by paying for a portion of charitable contributions, the government encourages such contributions and does so because the gifts will help

¹⁷ Further, as a general matter, many basic needs or traditional charitable organizations would be more adversely impacted by cuts to direct government spending than by changes to the charitable deduction – so if the goal is to protect basic needs organizations from harm, the charitable deduction is but one small piece of a broader policy issue.

produce important public goods, or goods that would not be provided independently by the market. Or, further, that the benefited organizations perform functions that would otherwise be performed by government and therefore should be supported by government.

Importantly, either rationale depends to a certain extent upon what we mean by public benefit. In particular, the subsidy rationale invites a critical question for policymakers, namely a subsidy for what? Given the large, diverse, and growing section 501(c)(3) sector, and the open-ended nature of the section 501(c)(3) exemption, it is difficult to pinpoint with particularity what is being subsidized under the current system or, perhaps more importantly, what is intended to be subsidized. Accordingly, if the reason for the deduction is to support the public benefits provided by the section 501(c)(3) sector, but the particulars of the subsidy are not known, it may be time for policymakers to reexamine the sector, and the rules that regulate it, to provide a clearer policy of public benefit.

Some will disagree with this and argue that a reassessment of the charitable deduction can and should be avoided by reliance on perhaps the best, in the sense of most accurate, explanation of current law: namely, that the public benefit served by the charitable deduction is not to produce any particular public good or goods but rather is to support the values of pluralism and private choice. Under this view, the point of the deduction is to foster broad based and generic altruism, without the government picking winners and losers (as the government does in direct spending programs). The government offers support, and individual donors and the section 501(c)(3) sector decide how the support is spent. An expansive view of qualifying section 501(c)(3) purposes and organizations fits well with this theory, because the government stands back and lets the sector evolve and grow consistent with social norms.

Although this view of the charitable deduction is appealing and reinforces current law, even here, as with a more concretized view of the public good, some change is warranted. As noted above, because of the tight link between the deduction and exemption, the main control on the charitable deduction is tax exemption law. But tax exemption law is largely bereft of bright lines or enforcement mechanisms, a condition that led recently to a spate of scandals and new legislation.¹⁸ Accordingly, if the support of the section 501(c)(3) sector as such is the rationale for the charitable deduction, then it is important also to be mindful of the negative symbols that can result when the sector is or is perceived to be either underperforming or prone to abuse of public trust – a condition that seems also to be part of the pluralistic model.

In short, the broad issue before you is to a certain extent a decision about what the charitable deduction is for – is it a subsidy, and if so for what? For a section 501(c)(3) sector like the one we have? Or for something else? And who should decide? Congress,

¹⁸ For a discussion of the recent reform legislation and the scandals that preceded it, see Roger Colinvaux, *Charity in the 21st Century: Trending Toward Decay*, 11 FLORIDA TAX REV. 1 (2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1809171.

or individual donors and the exempt sector? Further, what leverage should government have over the section 501(c)(3) sector through its support, direct or indirect?

Perhaps one way to crystallize the issue is to consider whether the charitable deduction should continue to be linked to section 501(c)(3) tax-exemption. Congress linked the two benefits in 1917, a linkage that arguably made sense at the time. The understanding of “charity” writ large was arguably closer to the statutory definition for exemption purposes, and Congress was concerned about the basic question of the proper tax base. The charitable deduction may well have been less of a subsidy than an income measurement issue. Today, however, with the deduction viewed as a government subsidy, and a vastly different section 501(c)(3) sector, there is to a certain extent a policy disconnect between the charitable deduction and the sector it supports. Arguably lost with the passage of time is a strong sense of the public benefit, or of charity in the charitable deduction.

D. Budget Pressure and the Charitable Deduction

That said, the immediate task for policymakers is not necessarily to rethink from first principles the role of the charitable deduction in the federal income tax, or the overall relationship of government and the section 501(c)(3) sector. Rather, major changes to the charitable deduction have been proposed, often in the context of deficit reduction, and their merits or demerits must be considered.

In general, the proposals fall into four categories: a cap on the value of the deduction, a floor underneath the deduction, conversion of the deduction to a credit, and replacing the deduction with matching grants paid directly by the government to the section 501(c)(3) organization.

An initial question is whether the charitable deduction is exceptional and should be considered separately from other itemized deductions. My view is that ideally, yes, the reasons for the charitable deduction are somewhat unique, the deduction is but one of many government supports for the section 501(c)(3) sector, and so better overall policy might follow if the deduction is tackled as part of a comprehensive review of the sector and all sources of support – that is, including direct government spending, as well as tax policy regarding charitable giving, exemption, and tax-exempt financing.

Nevertheless, if Congress determines that under present circumstances any cuts to tax expenditures should be broadly distributed, the charitable deduction could be changed and probably in a manner with limited impact on the section 501(c)(3) sector or the overall current policy of the deduction. Accordingly, one way to assess the various proposals is from the perspective of maximizing revenue gain while minimizing reform-oriented change.

Of the proposals, an income-based floor on charitable deductions appears best to fit within current policy tenets. A floor would improve the incentive aspect of the deduction by encouraging contributions at the margin. In other words, a floor would

reduce the windfall that many taxpayers receive for charitable contributions they would have made with or without a tax benefit, and so could make the deduction more cost effective. A floor would also have administrative benefits, by taking away opportunities to cheat on low-value contributions, and reducing the need to oversee many small dollar contributions, especially of noncash property. That said, however, some might argue that the floor would not be fair to those taxpayers who currently give at or below the floor. Such taxpayers might see their tax benefit eliminated, while others with more capacity to give, would continue to get tax benefits for giving.

The Administration's proposal to cap the value of all itemized deductions at less than the top rate of tax would be next on the scale of revenue raising changes with only modest immediate effects to the current structure. Unlike a floor, the impact of the Administration's proposal is more targeted in that it would only affect taxpayers in the highest rate bracket. The studies that have estimated its likely impact on giving suggest a small percentage decrease in giving. The section 501(c)(3) organizations affected would likely be those favored by the more affluent; data suggest this would tend to have less impact on basic needs charities.

However, there is a reform-based element to the Administration's proposal. By reducing the value of the deduction only for top rate payers, the proposal would have the effect of embracing as a matter of policy the argument that the current deduction is unfair. The unfairness argument stems from the progressive rate structure, which means that those in higher brackets get more value from a deduction, making charitable giving cheaper (and so providing a larger incentive) for those with higher incomes.

In my view, if the value of the charitable deduction does not automatically follow the rate structure, as under the Administration proposal, the most likely outcome over time is that the deduction will be converted to a credit. This is because any pretense of an income measurement rationale for the deduction will have disappeared, placing increased pressure on continued unfairness that would still be represented by the rate structure. In addition, once the value of the deduction becomes a policy choice distinct from the rate structure, future revenue needs will likely lead to calls for additional reductions to the value of the deduction, leading eventually to one or two rates – leaving the deduction looking increasingly like a credit.

A credit would be a clear break with current law. Although there may be good reasons to move to a credit, such a move might best be accomplished after considerable consultation with stakeholders. A credit (perhaps combined with a floor, as recommended by the Bowles-Simpson Commission) seems fairer than present law, in that all taxpayers, including nonitemizers, would have an equal incentive to give. However, depending upon its design, a credit might not be cost-effective. For example, a credit without a floor generally would be available to every dollar of contribution by nonitemizers, thereby to a certain extent unnecessarily rewarding existing giving patterns. In any event, in my view, conversion to a credit should be part of a broader discussion about the nature of the subsidy, and whether some parts of the section 501(c)(3) sector

should have bigger dollar incentives than others, perhaps through variable credit rates depending upon the recipient organization.

Of all the proposals currently under consideration, moving to a direct payment or grant system would be the most dramatic change from present law. Apart from requiring a new administrative apparatus to make payments and report contributions, a grant system likely would alter the character of the section 501(c)(3) sector. Many organizations that enjoy receiving deductible contributions and maintaining independence from government, might chafe at the idea of direct government support. In turn, government might demand more in terms of outputs because of the directness of the subsidy. This most certainly would affect the general independence of the section 501(c)(3) sector that the indirect subsidy allows.

E. Conclusion

By way of summary, the charitable deduction, and the rules governing tax exemption are in need of a critical examination. The focus of any such examination should be on whether existing rules are maximizing the public benefit at the lowest cost to taxpayers, including not only the charitable deduction, but tax exemption, direct grants, and other supports. Key to all of this is a better understanding of what we mean by public benefit, the role of the charitable deduction in the broader picture, and whether it should continue to be linked to standards for tax-exemption. Congress may of course decide to address the charitable deduction as part of its assessment of tax expenditures more broadly. If so, or if change is otherwise wanted without a broader reform effort, of the several proposals under consideration, a floor based on adjusted gross income appears to allow for cost-effective change within the existing policy structure.

Thank you for inviting me to testify and I welcome any questions.