

**Charities on the Frontline
and
Making the Best Use of Tax Policy to Help Them**

Statement of

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Mr. Chairman and members of the Subcommittee:

One response to Hurricane Katrina was a very generous outpouring of concern and care by Americans throughout the country. Many of our contributions could be handled immediately only because a solid infrastructure of charities already existed. Our many charities are a tremendous source of strength of which we can and should be very proud. On a personal note, I have been involved with charities at almost every level: as a recipient, as a contributor, as a founder, and as a researcher who studies charitable giving and charitable organizations.

The government interacts with charities and nonprofit institutions on a variety of fronts. Many of its payments flow through charities and provide health, education, and other forms of social welfare. Indeed, more money flows to charities from government fees and contracts than from individual and corporate contributions. With respect to both social welfare in general and to many specific instances of assistance, such as in New Orleans and neighboring areas, the government makes transfers to the needy that are much larger than those provided by individuals. The government often looks to charitable organizations to deliver its transfers because it views charitable organizations as efficient deliverers of services and goods. In many ways, charities and governments complement, rather than substitute for, each other.

The government also affects charities through the tax code. Tax provisions not only provide incentives but are also a powerful signal of the importance our society places on giving—a signal that likely increases giving beyond the pure incentive effect of possible tax savings the taxpayer might receive.

But we should make no mistake about it: the large amount of money flowing to charities from individuals and from government means that a lot is at stake. And because a lot is at stake, we must constantly examine whether that money is being spent well. Can incentives be improved? Can waste be reduced? Can sources of corruption be removed? Waste, inefficiency, and corruption affect more than just the money directly involved. When charities misbehave, for instance, people probably tend to give less and to trust less that charities serve them well.

In recent months and years, the Senate Finance Committee has heard testimony both on bills to expand incentives to give and on ways to reduce inefficiency and corruption within charities and the nonprofit sector. That these issues are by their very nature nonpartisan does not mean that they are easy. Tough choices are required. The two issues are really two sides of the same coin. They reflect the common goal of maximizing the good effects achieved by dollars Americans provide to charities both directly and through tax incentives provided to donors through the government. A combined legislative package could be a clear win-win scenario: good tax policy and good charitable policy. Done the right way, it could significantly increase charitable giving, improve tax compliance, and remove some sources of cheating and corruption associated with individuals and organizations. Think of it this way: every dollar spent on a weak incentive or to subsidize those who cheat is one less dollar available to strengthen the charitable sector in other ways.

I hope that Congress will pull together its two efforts—improving incentives and simultaneously reducing the corruption and noncompliance that remains within the charitable sector. Thus, I strongly recommend that you blend together additional charitable incentives with a clean-up of the charitable sector. One part of the legislative package would include the types of items contained in charitable incentive bills since 2001. The other would focus on curbing problems with charitable giving and governance and seek to improve the IRS's ability to monitor effectively in this arena.

What's the trick here? How can we make this into a win-win scenario? It's simple. Existing incentives in the tax system are not well designed. In addition, a fair amount of cheating takes place when it comes to charitable giving. For the amount of revenues foregone, therefore, much more charitable giving could be generated. The revenues lost because of cheating and lost on

that portion of giving unlikely to be responsive to an incentive could be reallocated to areas more responsive to giving. Meanwhile, these reforms could be done in a way that allows the IRS to better monitor claims of 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.

A combination bill is also a good way to address the necessary trade-offs in policymaking. Simultaneously trying to increase giving and making the money more likely to reach charitable beneficiaries gives Congress and the charitable sector a way of bargaining that goes beyond the one-item-at-a-time advocacy and reaction. Some charities, like some taxpayers, will take any benefit they can receive. And some would like to be left alone to take individual contributions and government subsidies with minimal transparent reporting to either donors or the IRS. When these issues are addressed one at a time, the representatives of the charitable sector are sometimes pushed to behave like a trade association—having to represent any potential loser rather than the well-being of the entire sector.

The net amount for charitable purposes is clearly a far more important consideration than the gross amount flowing through any particular charity. For instance, suppose a provision forces some charities to lose \$100 of contributions, of which only \$25 really ends up going to charitable recipients. Often the charity in question will end up fighting to protect the \$100 going through its organization, with the notion that at least some money is eventually going for good purposes. Suppose also that, in exchange, Congress offers charities, as a whole, subsidies likely to increase giving to charitable beneficiaries by \$30. Then, the net amount of real charitable activity is larger. There is not only more money available to ultimate beneficiaries, but also the economy as a whole is now more efficient and wastes fewer resources along the way.

A complex part of this equation requires considering the reputation of the sector as a whole. If a leaner and cleaner sector leads to more public giving, then that must be counted strongly on the benefit side of the equation. Admittedly, qualitative judgment is required. As an example, if some levels of compensation are considered excessive, then a judgment must be made whether restricting compensation yields more on net for charitable purposes or less in charitable output (over and above compensation) by those whose compensation is restricted.

What are some elements of a legislative package that might be considered? Many have already been included in different bills in Congress, although some need to be redesigned to enhance their effectiveness and likelihood to increase giving. Here are some examples:

Some Potential Elements of a Combination Legislative Package

1. **Adopt a deduction that is the same for non-itemizers and itemizers alike.** Charitable bills often offer an extension of deductions to non-itemizers, but generally fail to deal adequately with the design of floors and ceilings. (A floor provides a base under which deductions would not be allowed; a ceiling represents a maximum amount that can be deducted.) 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 (see Appendix). At the same time, ceilings reduce enormously the incentive effect of the tax break and should be avoided. The goal should be to increase giving per dollar of revenue cost but not add significantly to taxpayer and IRS administrative costs.
2. **Stop phasing out itemized deductions of charitable contributions.** Although this reform technically is not part of proposals that have a separate deduction for non-itemizers, the phase-out would be removed almost automatically if a common 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 is mainly a

backdoor tax rate increase. It should be abandoned. (Note that this issue becomes especially important if the phase-out of itemized deductions is retained, as many are now suggesting for deficit reasons.) At the same time, changes should not be enacted on a temporary basis, in this or other cases. Temporary changes are particularly challenging to the IRS and induce time-shifting moves, including shifts in giving over time that do not reflect aggregate increases in giving.

3. **Consider proposals to remove limits on charitable contributions, such as the proposal to allow contributions to be made from individual retirement accounts (IRAs).** Various versions of this proposal would allow money to be paid directly out of IRA accounts without having to be declared first as income subject to tax and then deducted. I 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 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 the Congress be able to monitor well exactly what is happening over time. This selective approach does grant only 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.
4. **Raise and simplify the various limits on charitable contributions that can be made as a percentage of income, such as the President's original 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 both to 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 the present circumstances of foundations.
5. **Allow deductions to be given until April 15 or the filing of a tax return.** This is the same rule that applies to IRAs and Keogh plans. If the tax system is to encourage giving, then the best time to advertise is when people are filling out their tax returns or their tax preparers are looking for additional ways to save them taxes. The long-term cost of this extension would be only a fraction of whatever increase in charitable giving might result since there is almost no cost unless giving goes up. Therefore, it would be one of the most effective measures that could be adopted in terms of induced charitable giving per dollar of revenue cost. To deal with some enforcement issues, however, this April 15 allowance might be allowed only for contributions accompanied by an improved reporting system, as is the case with IRA contributions. Otherwise, Treasury fears that some taxpayers would take the deduction twice, on April 15 of the year of deduction and then when filing the tax return for the next year. With IRAs, the issue is solved by the recipient charity working with the taxpayer to provide a 1099 indicating the year to which the deduction applies.
6. **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). Moreover, 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.

7. **Devote more IRS resources to helping the public monitor the charitable sector.** Within the IRS, the exempt organization function traditionally has been treated as an unwanted step-child because it brings in almost no revenue. (As noted, moreover, the IRS actually spends only a fraction of revenues from the foundation tax monitoring the nonprofit sector.) Today, however, there is an unusual opportunity that derives from a large confluence of charitable sector groups, researchers, state attorneys general, and private-sector information firms who are united in trying to clean up the charitable sector. One example is the electronic filing of tax forms, such as the 990 and 990 PF. 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) make it easier to make charitable donations over the Internet and reduce the paperwork exchange among charities (e.g., by foundations needing information on grantees). It also makes the IRS's job easier. Although the IRS is trying to help, it lacks resources. Congressional backing here—even if only a statement of congressional intent that electronic filing should be put in place quickly and that the IRS should demand more accurate filing of returns—could add to the momentum toward producing a more vibrant nonprofit sector.
8. **Change the foundation payout rule so that it does not encourage giving in a pro-cyclical manner.** A recent stock market bubble caused grants to rise dramatically for a few years, but a later recession and a bursting bubble tended 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. 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 higher or lower over time is a separate issue.
9. **Provide an improved reporting system to taxpayers for charitable contributions.** This would involve expansion of 1099 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 household goods alone, Congress ought to consider the Joint Committee on Taxation option to remove the deduction. I recognize that some charities would not be interested in improving the reporting system. The truth is, however, that the IRS simply does not and cannot enforce the law adequately as currently structured—just as it could not enforce well compliance on interest and dividends until information reporting was expanded to cover most of those payments.
10. **Limit deductibility for in-kind gifts where the net amount to charity is so low (because of payments to intermediaries) that the revenue cost to government is greater than the value of the gift made.** Alternatively, at least improve the information that donors receive. For instance, require that the charity must report to the taxpayer on the net amount received after payment to intermediaries, including advertisers, if this amount is less than, say, 50 percent of the value of the gift. Or require full and transparent public disclosure by fund-raising intermediaries of the amount of the gifts raised for *each* charity; the amount they, the intermediaries, received; the amount paid to other intermediaries, including for advertising; and the net amount turned over to the charity. These returns would be publicly available, just like the 990 returns of charities.

11. **Place limits or remove deductibility of pure cash contributions.** The IRS simply cannot enforce the law well where there is no check, credit card, receipt from the charity, or any other document that an IRS auditor can verify.

Further Analysis

In a well-designed legislative package, leaving out an option that raises revenue often means winning a battle and losing the war because it *reduces* the amount of charitable giving. All the compliance and revenue-raising options noted above are targeted to areas where there is cheating, misleading advertising, weak ability to enforce, invitations to corruption, and limited portions of contributions actually making their way to charitable purposes.

Some of the revenue-raising proposals—even with no offsetting expansion of incentives—might increase the net amount of charitable giving. Someone giving away, say, an automobile with a wholesale value of \$3,000 might alternatively sell the automobile and give the \$3,000 to charity, or make charitable contributions of \$2,500 if she had not given the automobile away. If only \$1,000 on net is making it to the charity when the automobile is given away because of all the fund-raising and advertising costs, then the net amount for charitable purposes has actually gone down. At a broader level, people are tired of reading about abuses of the charitable sector in areas like automobile donations, clothes donations, and easement rights. A sector that demonstrates more integrity in such areas is one that in the long run might very well attract more giving.

In many cases, charities that might be reluctant to take on some of these suggested limits or reporting requirements, considered in isolation, would find that they are much better off with the broader legislative package than without it. For instance, a floor under itemized deductions would have little effect on itemizers since it would have little effect on their marginal giving, but it would increase the amount of revenues that could be spent on expanding the deduction to non-itemizers. The additional reporting requirements make it easier to allow giving until April 15, which likely would increase giving significantly because it markets the tax incentive at the time the tax return is filed. A tighter restriction on cash contributions, which might at first appear to affect churches, is likely to be more than offset in value by the extension of a deduction to non-itemizers, since giving to churches is much more concentrated among lower- and middle-income taxpayers than giving to many other forms of charity. Keep in mind also that in churches, larger givers usually make use of envelopes, while those giving only modest amounts of cash are likely to be non-itemizers anyway.

On some of the options noted above, it will be hard to come up with a perfect revenue estimate. This places some risk that the revenue given away will be greater than or less than the revenue raised. I am reminded of the time in the 1980s when Congress required that Social Security numbers be reported for dependents. IRS research staff had long argued that there was substantial cheating here but had trouble coming up with an exact figure, even from their own audits. It turned out that there was much more than many expected, and the revenue pickup from this simple improvement in reporting was substantial. To me, however, the inexactitude of the revenue estimates creates little risk that the legislative package would decrease giving. Moreover, if desired, it would be possible to give regulators some authority to reduce a floor under deductions in some automatic fashion for future years when the total amount deducted in a given year came out to be less than some targeted amount.

Whatever this proposal's considerable advantages for reducing error and cheating, some may object to the cost of expanded information reporting for the charitable sector. After all, it would entail some expansion of its administrative responsibilities regarding charitable giving. For most charities, in truth, the net additional cost would be small because most already have a system in place to keep track of their donors and how much they have given. Even most churches now give taxpayers a statement at the end of the year as to the cash contributions they stick in envelopes.

Still, some software would probably need to be developed that would integrate current systems of reporting with any new system of reporting to the IRS, and there would be some transition costs.

Despite some additional administrative costs, information reporting reform would almost assuredly simplify tax preparation for individual taxpayers. Most taxpayers today no longer need to keep track on a separate ledger of their interest or dividends as they are received, but merely transfer to their tax return the information reported to them at the end of the year on information returns. If most charitable deductions were reported on information returns, they could stop keeping separate ledgers here as well.

Conclusion

Here, then, is an ideal trade-off. The monies derived from improved incentives, improved compliance, and a better system of information reporting could be spent on enhancing charitable incentives—extending the deduction to more taxpayers, raising the ceiling on allowed charitable giving for some types of gifts, and allowing taxpayers to benefit immediately from the charitable contributions they make while filing their tax returns. My guess is that the combination would increase giving and improve compliance at the same time.

One need not agree with every item I have suggested above. I have almost assuredly left out many worthwhile options. The Senate Finance staff is working closely with the Joint Committee staff, the Independent Sector, and others to offer ways (both public and private) of improving the behavior and operations of nonprofit organizations. Turning to disinterested staff to develop the options on which you vote is one of the best ways of striving for what Lincoln called “that perfect impartiality which has ever been considered the most favorable to correct decisions.” My principal suggestion is that you develop a legislative package that gives you the most bang per buck—maximizing giving per dollar of revenue cost while recognizing legitimate concerns for good tax policy and administration.

APPENDIX

WHY EXTENDING A DEDUCTION TO NON-ITEMIZERS REQUIRES A COMMON FLOOR FOR NON-ITEMIZERS AND ITEMIZERS ALIKE

Here, roughly speaking, is the rationale that leads to the need for a common floor if charitable deductions are extended to non-itemizers:

- **Step One:** IRS cannot accurately monitor small amounts of contributions. This means that Congress will need to 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. With a floor, the incentive is more likely to be confined to extra giving, where it is most effective. An incentive is not effective for the first dollars of giving—that giving that would take place even in absence of any 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 confusion for taxpayers. 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; 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. (If you're confused reading about this calculation, imagine tens of millions of taxpayers having to figure it out!) In addition, for some taxpayers, issues such as the phase-out of itemized deductions would affect whether 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. It also helps insure that there is no increase in the administrative burdens placed on an IRS that does not currently monitor well the deductions of itemizers alone.
- **Step Four:** Some of the costs of not adopting a common floor are not trivial: taxpayers' reaction against a more confusing tax return and charitable contributors' reaction against the increase in cheating that would arise.