

# CRS Report for Congress

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## Tax Incentives for Charity: An Overview of Legislative Proposals

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### Summary

This report briefly discusses the tax provisions of the Community Solutions Act (H.R. 7, which passed the House on July 19, 2001). A similar bill, also H.R. 7, was introduced in the 108<sup>th</sup> Congress. Provisions include charitable deductions for non-itemizers, rollovers of IRAs into charitable uses, a reduction in the excise tax on private foundation income, an increase in the deductions cap for corporate contributions, and several narrower provisions relating to business contributions of property and charitable remainder trusts. In 2002, the Senate Finance Committee also reported a substitute that included a number of similar provisions (The CARE Act of 2002), along with some revenue offsets (user fees and corporate tax shelters), which never saw floor action. A similar bill, S. 476, has been adopted by the Senate on April 9, 2003.

The Community Solutions Act of 2001 (H.R. 7), adopted in 2001 by the House, had eight new tax provisions designed to benefit charities and charitable giving. The bill also contained provisions relating to charitable choice (religious organizations' role in administering government programs).<sup>1</sup> The Joint Committee on Taxation projected a revenue loss of \$13.3 billion over 10 years \$2.4 billion annually when fully phased in on an annual basis. The President proposed three of these tax provisions in his original 2001 tax proposal, but these provisions were not included in the 2001 tax cut (P.L. 107-16). The President continued to propose revisions; his FY2004 tax proposals included most of these provisions but did not include the increase in limits for corporate contributions. S. 1924, introduced in the 107<sup>th</sup> Congress by Senators Lieberman and Santorum after discussion with the President, would provide a temporary non-itemizers deduction with a higher cap. The Senate Finance Committee reported out a version of the bill on June 18, 2002, the CARE Act of 2002, with a temporary non-itemizers deduction with both a floor and ceiling. It excluded some provisions of H.R. 7 but contained others. A similar bill, S. 476 estimated to cost \$11 billion over 10 years was passed by the Senate on April 9, 2003.

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<sup>1</sup> For a discussion of charitable choice provisions, see CRS Report RS20948, *Charitable Choice Provisions of H.R. 7*.

This report summarizes the tax provisions affecting charitable contributions and briefly reviews the issues in most cases. Provisions are discussed in order of their revenue cost in 2011 in H.R. 7, when fully phased in. A final section summarizes the major changes made by the Senate proposal and a possible floor amendment.

## Deduction for Non-Itemizers

Under current law a taxpayer can either itemize deductions (the major deductions are charitable contributions, excess medical expenses, mortgage interest, and state and local income and property taxes) or choose the standard deduction. The standard deduction is advantageous if that amount is larger than total itemized deductions. H.R. 7 would allow someone who takes the standard deduction to deduct charitable contributions in addition, but with caps as shown in Table 1. (The President's original proposal and his FY2003 proposal have no cap, while his FY2004 proposal has a cap and floor.)

The non-itemizer's charitable deduction was the single most important tax provision of H.R. 7, initially accounting for about one third of the cost, but by 2011 when fully phased in, would account for 48% of the total cost. This new deduction was not capped in the President's original proposal and was much larger (\$7.6 billion in 2011); it accounted for virtually all (94%) of the cost of charitable provisions in that year.

**Table 1: Caps on Charitable Contribution Deduction for Non-Itemizers in H.R. 7**

Year	Cap For Single Returns	Cap for Joint Returns
2002-2003	\$25	\$50
2004-2006	\$50	\$100
2007-2009	\$75	\$150
2010 and after	\$100	\$200

While the deduction for non-itemizers may increase giving, its effects would be limited, in large part because of the cap. The effect on charitable giving per dollar of revenue loss would be significantly increased if the cap were lifted or removed. Even without a cap, the deduction is unlikely to induce additional giving as large as the revenue loss because evidence suggests that the responsiveness of taxpayers, particularly lower and moderate income taxpayers, to incentives is small.<sup>2</sup> The provision would also increase complexity of tax filing by including another line item.

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<sup>2</sup> See CRS Report RL31108, *Economic Analysis of the Charitable Contribution Deduction for Non-Itemizers*.

A limited deduction for non-itemizers was formerly available for 1981-1986, enacted as part of the Economic Recovery Tax Act of 1981 (P.L. 97-34).

## **IRA Rollover Provision**

The second largest tax provision in H.R. 7 is one allowing tax free distributions from individual retirement accounts to charitable organizations by individuals aged 70 and 1/2 and over. While this treatment may appear no different from simply including the amounts in adjusted gross income and then deducting them as itemized deductions, it can provide several types of benefits even to those who itemize. Apparently an important motivation is to reduce adjusted gross income which can trigger a variety of phase-outs and phase-ins, including the phase-in of taxation of Social Security benefits. (Another potentially important phase-out effect, that for itemized deductions, is now scheduled to be eliminated.) There are also income limits on charitable contributions.

However, unlike the case in the President's proposal, this provision can also benefit those who take the standard deduction by allowing exclusions that would not be otherwise allowed. In effect, a return with the standard deduction would have no cap on charitable deductions up to the limit of aggregate IRA amounts, since the taxpayer could simply channel contributions through an IRA. (This effect did not matter in the President's proposal which had no cap).

This provision accounts for 29% of the estimated revenue cost in the first full year, and 18% in the long run according to the Joint Committee on Taxation. Since IRAs tend to be held by higher income individuals, the taxpayers might be somewhat more sensitive to the incentive to give; however, it is not clear why this particular group of taxpayers is targeted.

## **Reduce the Excise Tax on Foundation Investment Income**

Under current law, there is a 1% tax on investment income of foundations, and an additional 1% if the foundation does not make a certain minimum distribution (based on distributions made in the previous 5 years), or has been subject to a tax for failure to distribute in the previous 5 years. H.R. 7 would eliminate the extra 1% tax. This provision accounts for 32% of the revenue cost in the first year, but 12% in the long run.

Private foundations, whose contributors (or their families) retain the right to direct the distribution of funds, have always been subject to greater scrutiny, in part because of the possibility of the donor (or family ) obtaining a private benefit. Foundations are required to distribute 5% of their assets each year (or pay a penalty), but the tax is credited against that distribution.

If the foundation is just making the minimum distribution, every dollar of tax reduction should be funneled into distributions. Moreover, the moving average discourages a large contribution in a particular year. The reduction in the investment tax would also make private foundations more attractive in general, although that increased attractiveness might in part induce more contributions, and in part replace contributions

that might have gone to other charities. The effects should be small, however, because the tax is small.

Proponents of reducing the tax also argue that it should be reduced because it brings in revenue that is in excess of IRS audit costs, which they indicate was the original purpose of the tax (which was introduced in 1969). The revenue stream from this tax has, however, been quite variable recently because it is heavily affected by the stock market. In any case, a reading of the legislative history indicates that while the Senate characterized the tax as an audit fee, the House referred more generally to the notion that private foundations should bear part of the cost of government generally because of their ability to pay (as well as viewing it in part as a user fee), and both objectives were cited in the final explanation of the bill. It was reduced twice (in 1978 and 1984) based on the argument regarding costs of audit versus revenue.

Another argument made for eliminating the additional tax is the additional complication arising from it. Of course, one could as easily simplify by converting the entire tax to a flat fee; simplification does not require reduction.

The current version of H.R. 7 adds a new provision that disallows the counting of administrative costs as part of a foundation's minimum distribution requirement. Foundations are required to make a minimum distribution of 5%, but that 5% can currently include administrative costs (which currently have only to be "reasonable"). This provision reflects a concern about excessive administrative costs, but has also resulted in some criticism by foundations as ultimately reducing foundation endowments.

## **Raising the Cap on Charitable Deductions of Corporations**

Under current law corporations can deduct charitable contributions of up to 10% of income; the proposal would gradually raise the cap to 15%. This provision accounts for 8% of the first year cost, and 11% of the final cost. Most corporate giving already falls well under the cap; the average giving is less than 2% of income.

There has been some dispute over a corporate charitable deduction, since shareholders could make their own decisions about charitable giving. In some views, charitable giving by corporations is another management perk that might be excessive because of monitoring problems by shareholders (this problem is also called an agency cost problem). Others argue that corporations should be encouraged to give to charity and to be socially responsible. Economists have studied models in which charitable giving is part of the firm's profit maximizing behavior (e.g. by gaining the firm good will). Evidence on the effectiveness of the deduction is mixed, with time series studies showing a positive effect and cross section results not finding an effect.<sup>3</sup>

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<sup>3</sup> See James R. Boatsman and Sanjay Gupta, "Taxes and Corporate Charity: Empirical Evidence from Micro-Level Panel Data," *National Tax Journal*, Vol. 49, June 1996, pp. 193-213.

## **Extend Present Law Section 170(e) Deduction for Food Inventory to all Businesses**

Under present law, firms that donate inventory to charity in general get a deduction for the cost (not the market value). A special rule allows businesses paying the corporate tax to also exclude half the appreciation (half the difference between market value and cost of production, if the inventory is given to an organization that directly passes it on to the ill, the needy, or infants, as long as the total deduction is no more than twice the cost. An important category of donations is that of food and there have been disputes between taxpayers and the IRS about how to measure the fair market value of food. Under the bill, unincorporated businesses (or businesses that are incorporated but do not pay the corporate tax) would also be allowed the additional deduction, and the fair market value of wholesome food would be considered the price at which the firm is currently selling the item (or sold it in the past). This provision accounts for 7% of the first year cost, and 3% of the cost in 2011. (The President's 2003 budget would allow all of the market value to be deducted, but retains the two times basis restriction).

The objective of the provision is to create more equity among types of taxpayers and resolve disputes (largely in the taxpayer's favor). However, one important concern about donated inventory is whether firms might be profiting from charitable contributions for items that they could not otherwise sell.<sup>4</sup>

## **Modify the Basis of S Corporation Stock for Certain Charitable Contributions**

Under current law, a shareholder in a Subchapter S corporation (a corporation treated as a partnership) is allowed to deduct his or her pro rata share of any corporate contribution. At the same time, the taxpayer must decrease the basis of stock by that amount (which is a way of reflecting the effect on the shareholder's asset position). The bill provides that the taxpayer will not have to reduce basis in the stock to the extent a deduction is taken in excess of adjusted basis of the donated property (e.g. cost). This provision appears to be consistent with allowing a deduction for the market value of appreciated property without including the appreciation in income (a special benefit generally available to taxpayers). This provision would cost almost 3% of loss in the first year, and slightly over 2% in 2011.

## **Modify Tax on Unrelated Business Taxable Income of Charitable Remainder Trusts**

Current law provides tax deductions for some portion of a trust and income tax exemption on the earnings, if a remainder of the assets is left to charity (while paying income to a non-charitable donee, usually a spouse or other relative during an interim

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<sup>4</sup> See CRS Report RL31097, *Charitable Contributions of Food Inventory: Proposals for Change Under the Community Solutions Act of 2001*.

period). The trust's income is, however, no longer exempt from tax if the trust has unrelated business income. This provision liberalizes the rule by providing for a 100% excise tax on any unrelated business income rather than loss of all tax exemption. This provision accounts for a negligible share of the cost (less than ½ of 1%).

## **Modify the Self Constructed Property Rules for Certain Charitable Corporations**

Certain special treatment (similar to that for food inventory) is allowed for certain scientific property used for research and for contributions of computer technology and equipment, provided the property is constructed by the taxpayer. In concrete terms, this rule requires that no more than 50% of the cost is due to parts purchased elsewhere. This bill would allow property assembled, as well as constructed.

## **Modifications in the Senate Proposal**

In the 107<sup>th</sup> Congress, the Lieberman-Santorum plan, S. 1924, would have provided non-itemizers deductions with a cap of \$400 (\$800 for joint returns); the Senate Finance Committee reported a version of S. 1924 (as a substitute for H.R. 7) with a temporary non-itemizers deduction with floor and a ceiling (\$250/\$500 for singles and \$500/\$1000 for joint returns). A similar bill was introduced as S. 476 in the 108<sup>th</sup> Congress, with charitable provisions costing \$11 billion from 2003-20013, with \$2.8 trillion due to the 2 year non-itemizers deduction. This bill was passed by the Senate on April 9. The proposal includes the IRA rollover provision but not the foundation excise tax reduction or the increase in corporate contributions cap. The remaining four minor provisions of H.R. 7 are included although the self-constructed property provision is temporary. There are also a number of additional provisions, although some of them relatively small. Another important set of provisions relate to benefits for contributions for conservation purposes including a 25% exclusion from capital gains on the sale or exchange of property to the government for conservation purposes (\$766 million) and lifting contribution caps for contributions for conservation purposes (\$332 million). A third provision is allowing the food inventory treatment for book inventories as well (\$283 million). There are a number of minor provisions as well. The bill also includes increases in grants, as well as revenue offsets relating to tax shelters and user fees.

A Senate floor amendment allowing up to 10 years to eliminate excess holdings of stock to avoid a heavy tax on excess business holdings was adopted. This provision would cost \$129 million over 10 years. Some indications have been made that Wal-Mart is a firm that may especially benefit from this change. In the 107<sup>th</sup> Congress consideration of the bill, this provision substituted for an amendment proposed, but then withdrawn, during committee consideration which would have raised the limit on holdings in one firm from 2% to 5%. Another amendment passed on the Senate floor extended the 25% capital gains exclusion for land sold to any charity regardless of the purpose.