TOWARD MORE SIMPLE AND EFFECTIVE GIVING: REFORMING THE TAX RULES FOR CHARITABLE CONTRIBUTIONS AND CHARITABLE ORGANIZATIONS

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TOWARD MORE SIMPLE AND EFFECTIVE GIVING: REFORMING THE TAX RULES FOR CHARITABLE CONTRIBUTIONS AND CHARITABLE ORGANIZATIONS

PREFACE AND INTRODUCTION TO THE STUDY

The attention of federal policy makers today is devoted increasingly to making the government work more effectively. At the same time, there has been growing recognition that the public and charitable sectors are mutually dependent in promoting the common good and confronting social problems. In such a period, we believe that it is timely to examine the government's relationship to the charitable sector.

This paper focuses on some important, but largely neglected, aspects of tax policy toward charitable contributions and charitable organizations. Despite the presence of tax incentives for charitable giving, numerous impediments weaken these incentives or add undue complexity, often without regard to any underlying principle. Many of these impediments also create significant complications for the taxpayer, the charitable sector, and the IRS itself.

We do not expect all readers to agree with all the suggestions made in this paper. Our primary hope is that we can persuade them that a moderate amount of cleaning and fixing can make the tax code work more effectively and simply with respect to charitable giving and charitable organizations.

Part I of the study concentrates on a variety of confusing and complicated limitations on deductions for charitable contributions, all of which are related to the income of the taxpayer or the percentage of income given to charity. Part II focuses specifically on valuation of appreciated property donated to private foundations. A proposal to allow charitable giving to be deducted -- like individual retirement account (IRA) contributions -- up to April 15 of the following year is detailed in Part III. Part IV discusses a variety of unnecessary complications that surround the excise tax on investment income of private foundations. Possible methods of improving disclosure are examined in Part V. Part VI proposes a package of simplifying reforms that builds on the previous parts of the report.

PART I. LIMITATIONS ON THE ITEMIZED DEDUCTION FOR CHARITABLE CONTRIBUTIONS

A. INTRODUCTION

The tax laws usually provide financial rewards for donors, but they can also make life complicated for those philanthropically inclined. Section 170 of the Internal Revenue Code on charitable contributions and gifts fills seven pages of small print. The corresponding regulations cover 108 pages. A significant portion of this complexity is the result of a variety of limitations on the deduction for charitable contributions.[1] A whole set of limitations apply specifically to charitable deductions above a certain percentage of income. Different percentage-of-income limitations apply according the type of gift and according to the type of recipient organization. Cash contributions are allowed only up to 50 percent of adjusted gross income (AGI), while other types of contributions are restricted to either 30 percent or 20 percent of AGI. Other requirements restrict charitable contributions for gifts of appreciated property to foundations in ways that do not apply to other charitable organizations. In addition to the percentage-of-income limitations, there is a modest cutback in the overall itemized deductions of upper-income households. Finally, deductions are also limited to charitable contributions made in the calendar year for which filing is made, as contrasted to individual retirement accounts (IRAs) and Keogh accounts, for which deductions are allowed for transactions made up to time of filing or April 15.

This section examines the current system of itemizing deductions for charitable contributions to identify some realistic simplifications and reforms -- within the assumption that deductibility and the positive incentives it creates are desirable. We do not address reform proposals that would replace deductions with credits and/or extend deductibility for charitable contributions to nonitemizers.

B. BACKGROUND ON THE CHARITABLE DEDUCTION

1. The Charitable Deduction as an Incentive for Charitable Giving

Two principal justifications are usually offered for the charitable deduction. The first is that the charitable deduction provides a tax incentive for contributions to appropriate causes. Richard Goode (1976) argues that incentives were the primary purpose of the deduction. It follows from this view that attention should be given to identifying causes worthy enough to qualify for the tax benefits. The variety of requirements placed upon "qualification" as a charitable or philanthropic organization can be viewed as one way of targeting this incentive.

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[1] Although a central theme of this paper is the unnecessary complexity encountered by taxpayers through direct giving, there is far greater complexity in the tax rules surrounding charitable trusts. Discussion of these issues is beyond the scope of this paper. For further background, see, for example, Hopkins (1991). It is interesting to note that estates and trusts, unlike individual and corporate taxpayers, do not encounter any percentage-of-income (or similar) limitations on their gifts to charity.

Closely related to the incentive goal is the belief that the philanthropic sector represents a third sector that sometimes can meet needs better or more efficiently than the government or the individual acting on his or her own behalf. The argument is that it can experiment in unique ways and is not always bound by the same requirements that restrict and limit government activity. In many respects, the sector helps fill a middle ground between a totally individualistic and a totally socialistic society. Thus, the incentive does more than facilitate particular forms of transfers; it helps maintain institutional structures that provide alternative and competitive ways of achieving social goals. Such competition would not be obtained if the government were merely to allocate spending directly to its own functions.

As an incentive for charitable giving, the subsidy rate provided by the charitable deduction is equal to the marginal statutory income tax rate (including surtaxes, but not various phase-outs, as discussed below). Alternatively, the charitable deduction provides the economic equivalent of a matching grant from the government to the charity of a donor's choice. In the simplest case, the matching grant rate is positively related to the donor's marginal income tax rate. Take a taxpayer with a marginal tax rate of 40 percent: for each (pre-tax) dollar contributed, the government covers 40 cents of the cost. Since this 40 cents amount constitutes two-thirds of every after-tax dollar, the taxpayer in effect has a matching grant rate of almost 67 percent for his or her actual contribution.[2]

2. <u>The Charitable Contribution as Necessary for Correct Measurement of the Income Tax Base</u>

A second principal justification for deductibility of charitable contributions is that it is appropriate for income measurement purposes (Andrews, 1972). The income measurement view can be explained in terms of the principle that taxpayers should be assessed on the basis of their "ability to pay," and those with equal ability to pay should pay equal amounts of tax. It could be argued, therefore, that charitable contributions should be deducted from income in determining ability to pay because contributions to charity are different conceptually from income to be spent for personal consumption. Charitable contributions are, then, a form of deductible transfer. Once contributed, the donor has neither the ability to use these funds for his or her private benefit nor the same ability to pay taxes as before the decision to give.

Consider two taxpayers, one with $50,000 of income and $10,000 of charitable deductions, another with $40,000 of income and no charitable deductions. Both have $40,000 left for their own consumption and, hence, can be viewed as having equal ability to pay (or to consume) after the contributions have been made. Further, because a large portion of charitable contributions is used to support efforts that might otherwise be funded by direct government expenditures, contributions can be likened (if imperfectly) to a tax payment, which

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[2] More generally, the matching grant rate can be represent algebraically with the formula $m = t/(1-t)$ where t is the donor's marginal tax rate. A donor with a 40-percent tax rate makes available 67 cents of public funds for every $1 donated. A donor in the 15-percent tax bracket makes available 15/85, or approximately 20 cents, of public funds for every $1 donated. Taxpayers facing percentage limitations have somewhat lower matching rates. Taxpayers contributing appreciated property where deductions equal full market value receive larger matching grants.

is usually deductible.[3] Indeed, certain taxes that are considered equivalent to taxes on income are even allowed as credits against federal income tax.[4]

Although the case is far from perfect -- private charity and governmental activities are not perfect substitutes and, unlike a tax, charitable contributions are always voluntary[5] -- the measurement of income argument enhances the incentive argument for a deduction. This paper proceeds on the assumption that Congress continues to find the charitable deduction meritorious and wishes to implement it in an effective manner. In a number of cases, we will examine alternative methods of simplifying or reforming the deduction in a way that would both enhance its incentive effects and be consistent with the objective of defining the tax base of individuals in an equitable manner.

C. LIMITATION ON ITEMIZED DEDUCTIONS FOR UPPER-INCOME HOUSEHOLDS

As part of the deficit reduction package enacted in 1990, Congress created new IRS Code section 68, which imposed a reduction on itemized deductions for high-income taxpayers. For a taxpayer with adjusted gross income (AGI) in excess of an applicable amount ($111,800 in 1994),[6] each additional dollar of AGI reduces total itemized deductions by three cents. Thus, a taxpayer with AGI $10,000 greater than the applicable amount must reduce total itemized deductions, including charitable contributions, by $300.[7] When the general three percent reduction applies, its effect on the subsidy for charitable giving depends upon the amount of charitable deductions, the amount of itemized deductions, and their relationship to AGI. Generally, the smaller the total deductions and the higher the charitable

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[3] See, Schiff (1985), pp. 535-546.

[4] If charitable activities and government activities are substitutes, the nongiving taxpayer (e.g., with $40,000 of income in the example) may gain as well from the activities of giving taxpayers, even after taking into account the value of the charitable deduction allowed them. He may benefit from the charitable services made available from contributing taxpayers and he may pay lower taxes if the charitable contributions reduce the amount of government services required. From another angle, in the example the two taxpayers can be viewed as paying the same amount to the public good on the first $40,000 of income, while the giving taxpayer also pays 100 percent of the excess income over $40,000 for public purposes. While starting out with higher potential consumption, the giving taxpayer ends up in this example with the same potential amount of consumption only if there is a charitable deduction. To tax her on the $10,000 of charitable contributions would require that she incur an even lower level of consumption than the taxpayer with $40,000 of income.

[5] See Clotfelter and Steuerle (1981) for further discussion.

[6] For a married individual filing a separate return, the applicable amount is approximately $53,000. These amounts are adjusted each year to take into account changes in inflation.

[7] There is an 80-percent limitation on the extent to which itemized deductions can be reduced, although few taxpayers hit that limit. When the 80-percent limitation is in effect, an additional dollar of contributions can lead to a loss of 80 cents of deduction.

deductions relative to total AGI, the more likely is there to be a reduction in tax benefits for charitable contributions. Under the general rule, only additional AGI -- not additional deductible expenses -- reduces allowable deductions.

As AGI increases, taxable income goes up by the dollar of increased AGI plus the 3 cents of additional denied deduction. The section 68 limit creates a new set of tax rates equal to 1.03 times the statutory rate for taxpayers with AGI in excess of the applicable amount. For a taxpayer in the 39.6 percent bracket, for instance, the limitation imposes an additional tax rate on the extra income of approximately 1.2 percent (.03 x 39.6), resulting in a combined tax rate of 40.8 percent.

Section 68 will have little impact on the *marginal* incentives for giving in most cases. Suppose, for instance, that a taxpayer has income taxes to state and local governments or other noncharitable deductions in excess of three percent of AGI. Since the reduction in itemized deductions is never more than three percent of AGI, there are enough noncharitable deductions to "eat up" the penalty. Any additional charitable contributions after that point add fully to the amount of itemized deductions that can be taken.[8] For the taxpayer in the 39.6 percent bracket, all charitable contributions effectively receive a subsidy rate of 39.6 percent. At the margin, all charitable contributions may be viewed as fully deductible against the normal income tax rate. Even if some contributions are limited, the limitations are most likely to affect the first dollars given -- those that might be given without any incentive -- rather than the "marginal" or last dollars given.[9]

The purpose of the itemized deduction rollback was to raise effective tax rates without raising statutory rates. In terms of providing incentives for charitable giving, the choice by Congress to raise effective, but not statutory, rates is significant. A straightforward rate increase would have maintained the subsidy rate for charitable giving at the full effective tax rate. Under current law, however, the 39.6 percent tax-bracket taxpayer in our example in reality faces a 40.8 percent tax rate on income, but receives only a 39.6 percent tax reduction on deductions taken. The deduction rollback, therefore, denies to charitable giving the incentive effect that applies to the total tax rate.

A similar objection can be raised to the personal exemption phase-out. In reality, it was designed mainly to increase tax rates -- but without the increase being so obvious as to be reflected in the formal rate schedule. It, too, imposes a higher tax rate on income earned than the subsidy rate on that income when given to charity.

From an income measurement standpoint, a taxpayer who earns an additional dollar and gives it to charity will pay more tax than one who earns that dollar and does not give it away. Imagine in the extreme a tax code that assessed all taxes through such back door

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[8] We assume here that the taxpayer does not use the standard deduction.

[9] Suppose a more restricted and unlikely set of circumstances: a taxpayer has itemized deductions only for charitable contributions of $10,000 and an itemized deduction cutback of $1,000. Any giving over and above $10,000 (and most giving even below the $10,000 amount) still receives a subsidy at the normal income tax rate, including surtaxes.

approaches or through taxes other than the income tax. In effect, the deduction for charitable giving would be eliminated.

We suggest that both the itemized deduction phase-out and the personal exemption phase-out should be replaced with a more transparent assessment of tax rates. The provisions are complicated and difficult to understand. Indeed, there is strong evidence that the approaches were adopted mainly for reasons of appearance; they were picked over other options that could achieve the same objective in a more straightforward manner. The political climate dictated a tax increase on high-income taxpayers, but a more straightforward increase in marginal rates for upper-income households was deemed unacceptable. Hence, the back door was chosen. There is little indication that members of Congress actually intended to penalize charitable giving.[10]

D. The Percentage-of-Income Limitations on Gifts to All Donees

1. Introduction

Under current law, several limits on charitable contributions are expressed as a percentage of income. Total contributions may not exceed 50 percent of adjusted gross income (AGI). Cash -- and appreciated property for which the donor has elected to deduct only the property's basis -- is first deductible under this limit. To the extent the limitation has not been exhausted by these items, contributions to private nonoperating foundations and selected other nonprofit organizations generally may be deducted up to 30 percent of AGI. Gifts of appreciated property to public charities also face a special limit of 30 percent of AGI. Donations of appreciated property to nonoperating private foundations may never exceed the lesser ceiling of 20 percent of AGI. Deductions in excess of these limitations may be carried forward five years subject to a complex set of rules.

As noted above, if AGI exceeds certain thresholds, charitable contributions may be limited (along with other itemized deductions), regardless of amount or characteristics of the contributions. Thus, in some cases, the AGI of the donor determines which limitations apply. In other cases the character of the property (cash vs. appreciated property) is what matters. And in yet other cases the characteristics of the donee (i.e. private nonoperating foundation vs. public charity) determine the nature of the limitations.

In theory, the various criteria for deductions for charitable donations might be argued to reflect numerous policy objectives pursued by Congress. In practice, however, we find that the various instruments chosen operate randomly and arbitrarily across taxpayers and types of giving. In this section and the next -- where we deal in additional detail with percentage-of-income limits that apply to private foundations -- we will discuss some potential objectives of each limitation, how well each provision achieves these objectives, the complexity involved, the economic incentives actually wrought by each limitation, and some sensible reforms of these provisions.

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10 Note, by the way, that little is gained by simple removal of charitable contributions from those itemized deductions subject to the three percent limit. Charitable contributions would still not be fully deductible at the higher, "real," tax rate.

2. The 50 percent Limitation: an Errant Minimum Tax

General Critique. An overall limitation on charitable contributions is generally inconsistent with both the tax-incentive and the income-measurement justifications for deductibility of charitable contributions.[11] If deductibility is allowed specifically to encourage giving, it makes no sense to weaken the incentive as the size of the gift relative to income becomes large. Similarly, if deductibility for charitable contributions is designed to more properly measure taxable income, the size of the gift relative to income is surely irrelevant.

Note that if a taxpayer donates his or her own services to a charity, the gift is effectively deductible without limitation. Thus, the percentage of income limitation tilts the playing field in favor of those individuals who provide services directly to charity rather than work for pay outside the charitable organization and then donate to charity out of that pay.[12]

The limitation may be viewed as vertically inequitable; why should deductions for gifts by an individual earning $40,000 and contributing $25,000 be limited when a $25,000 contribution by an individual earning $100,000 (or $1,000,0000) is fully deductible? In effect, if a minimum-tax approach is sought for high-income taxpayers, the 50 percent limit for all taxpayers is not the way to achieve it. The 50 percent limitation was enacted into law as part of the Tax Reform Act of 1969. It is both useful and entertaining to follow some of the actual reasoning behind it, as explained by Edwin Cohen:

> We had decided at the Treasury, before we met with the President [Nixon] in April, to recommend that those who qualified should be permitted to deduct contributions up to a limit of 80 percent of their income instead of 100 percent, in keeping with our basic theme that, to the extent possible, the law should require everyone to pay some amount in support of the government if they are financially able to do so. Those persons who do not meet the special qualification test would be limited in their contribution deductions to 30 percent (in some case to 20 percent) of their income.
>
> When we were in the Cabinet Room on April 16, 1969, reviewing with the President our 16 principal recommendations for tax reform, I called his attention to this recommendation. The President responded that while he had no objection to our recommendation for the cutback in the unlimited deduction, he had always thought the law ought to permit everyone contributions up to *half* of his or her income [italics ours]. Under such a rule, except for the few who would be entitled to the proposed new 80 percent limit, a person would be taxable

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[11] As we shall see below, in most circumstance the economic impact of the 50 percent limitation is small. In some cases, the limitation may actually be advantageous to the taxpayer.

[12] In practice, of course, such services would be impossible to tax. But even in theory no one seems to be bothered by the ability of a volunteer to eliminate tax liability through the equivalent of a complete deduction for 100 percent of income earned and given away. Unfortunately, when an individual is less efficient in donating services -- e.g., because of a superior capability of performing other types of work -- the tax rules encourage the more inefficient form of donation. In addition, for certain religious orders, a 100 percent deduction may be allowed in cases where there is a "vow of poverty" and the individual is somehow "deemed" not to have received the income as compensation for work.

on half of his income, but not on the other half that he gave to charitable and education institutions of his own choice. I replied that I thought his concept could be incorporated in our proposals as long as the other reforms we were recommending in the contributions area were retained. We made the change in our proposals before we presented them to the Ways and Means Committee on April 22, 1969.

When the dust cleared by the end of 1969, the Congress did increase the limitation to 50 percent, as the President advocated. The President's quick response to me in the Cabinet Room found its way into the final bill. However, the Congress decided to repeal the unlimited deduction entirely by phasing it out gradually over a period of five years to end completely in 1974, and did not enact our proposed special category that would have permitted deductions up to 80 percent of income in some cases.[13]

Economic Impact of the 50 percent Limitation. The overall impact of the 50 percent limitation can be expected to be fairly modest, since few taxpayers make gifts of that magnitude. Even for donors affected, charitable deductions of 50 percent of income, plus other deductions, may have already reduced taxable income enough that the marginal tax rate applying to excluded contributions is low. Finally, even those who give more than 50 percent in a given year can carry the excess over to another year since any deductions on excess of the limitation may be carried forward five years.

Among wealthy donors, however, the limits probably discourage giving more for psychological and administrative reasons than purely economic ones. Given the amount of effort involved in dealing with the limitations, some individuals may "play it safe," giving safely less than the limit so as not to go over that amount when they finally calculate their total income during the filing season. In a recent survey study of more than 135 millionaires -- the vast majority of whom regularly give large sums to charity -- one conclusion was particularly telling. "A majority of informants told us," the authors reported, "we give as much as **allowed**." In effect, these givers cited the parameters of the tax code as defining what they considered doable. In Odendahl's words, "Most said they contribute up to the maximum for which they can receive a deduction."[14]

The laws of the United States do have a "signaling" effect, as when individuals determine their age of retirement by ages set in the Social Security Act or try to operate just below some limit set in the law whose real economic effect they little understand. There is also evidence that apparent complexity reduces incentives by far more than is implied by their economic effect. When individual retirement accounts (IRAs) were made only modestly more complicated for higher-income taxpayers, for instance, middle-income taxpayers unaffected by the change reduced their IRA contributions considerably.

In another study, Steuerle (1987) found that in one year wealthy taxpayers recognized only about two percent of their net worth as income subject to tax. Hence, individuals without earned income can easily be confined each year by the 50 percent limit to giving away only about one percent of their net worth to charity. This giving will be far less than actual income

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[13] Edwin S. Cohen (1994), pp. 368-369.

[14] Odendahl (1987).

typically earned on that net worth, however, because of unrealized asset appreciation. Those inclined to be generous in years prior to death face a very limited income tax incentive already, since the 5-year carryover provisions are less likely to prove relevant. Various limitations, such as the 50 percent limit, reduce that incentive even further. Reluctance of potential givers to deal with these complexities may be followed by later negligence, and opportunities to get more in the giving habit are increasingly forgone.

Smoothing of Charitable Giving. A taxpayer can mitigate the impact of the 50 percent limitation by smoothing charitable giving. For example, suppose a donor with constant AGI of $100,000 wished to contribute a total of $300,000 over the current and next five years. Uniform contributions of $50,000 in each year would eliminate its impact. However, avoidance of the 50 percent limitation with such single-mindedness is not necessarily optimal for the taxpayer.[15]

In some situations, the tax factor of overwhelming importance that motivates smoothing of charitable giving is the desire to minimize the effects of graduated tax rates. What smoothing allows -- that immediate deduction does not -- is somewhat greater control of the use of other deductions, exemptions, and standard deductions. This can be seen most easily by an example. Suppose a married couple with no children has adjusted gross income of $96,000 in year 1, $55,000 in year 2, $60,000 of charitable contributions in year 1 only, and $8,000 of other itemized deductions in both years. Under 1993 rate brackets and personal exemption and standard deduction amounts, the following table shows that the household pays ***less*** tax (in both absolute and present value terms) under current law than under simple repeal of the 50 percent limitation.

In this case, even though the 50 percent limitation delays the benefits of tax deductions, it moves some charitable deductions to the second year -- when they reduce taxable income at a marginal rate of 28 percent, instead of remaining deductible in the first year at a marginal 15 percent tax rate. It is also possible for the intertemporal reallocation of income dictated by the 50 percent limitation to work in the opposite direction -- rerouting income tax deductions to years where income is subject to a lower rate.

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[15] The taxpayer must also take into account how close she is to the limit. Earlier giving allows the charity (rather than the donor) to earn investment income. Investment income earned by the charity faces no limitation, but if earned by the taxpayer and then given away could increase the amount of giving subject to the 50 percent limit.

Example: How the 50% Limit Can Reduce Taxes in Absence of Tax Planning

	With 50% Limit	Without 50% Limit
YEAR 1		
Adjusted Gross Income	96,000	96,000
Charitable Deductions	48,000	60,000
Other Deductions	8,000	8,000
Personal Exemption	5,200,	5,200
Taxable Income	34,800	22,800
Tax	5,220	3,420
YEAR 2		
Adjusted Gross Income	55,000	55,000
Charitable Deductions	12,000	0
Other Deductions	8,000	8,000
Personal Exemption	5,200	5,200
Taxable Income	29,800	41,800
Tax	4,470	6,907
Total Adjusted Gross Income	151,000	151,000
Total Charitable Deductions	60,000	60,000
Total Other Deductions	16,000	16,000
Total Personal Exemption	10,400	10,400
Total Taxable Income	64,600	64,600
Taxable Income @ 15%	64,600	59,700
Taxable Income @ 28%	0	2,200
Total Tax	9,690	10,327
Present Value of Tax	9,359	9,815

The 50 percent Limitation as a Mechanism for Limiting Government Outlays. If the matching grant analogy is adopted, one could argue that the percentage limitations serve a useful purpose because the government wishes to restrict the amount of its matching grants. A variety of mechanisms, however, could serve this purpose. For instance, a floor (deductions for contributions only above some minimum) rather than a ceiling could be applied, thus allowing the incentive to apply more at the margin. Limiting any particular individual's matching grants seems to aim more at controlling an individual on some "minimum tax" type of logic, as discussed below. Even if aimed at limiting matching grants, the reasoning might be more likely to lead to a per capita limitation than an income limitation, unless it was believed that those in the upper income brackets should have discretionary use of larger absolute amounts of funds.

The 50 percent Limitation as a Minimum Tax. Almost all roads that we have pursued leads us back to the same conclusion about intent of the 50 percent limitation: that it most likely is meant to address concerns analogous to those used to motivate a minimum tax -- namely, no taxpayer should be able to eliminate his or her entire tax liability through a combination of deductions, credits, and exclusions, no matter how meritorious their purpose.

The history of the 1969 Act seems to support this conclusion. In repealing an unlimited charitable deduction (available only to a few taxpayers), the Joint Committee indicated that "the charitable contributions deduction has permitted a number of high-income persons to pay little or no tax on their income. It appeared that the charitable contributions deduction was one of the two most important itemized deductions used by high-income persons, who paid little or no income tax, to reduce their tax liability."[16]

The 50 percent limitation by itself, however, cannot achieve this minimum tax objective. The minimum tax applies only to upper-income households. The limitation may apply to taxpayers who do not enjoy any other tax advantages and pay tax at a respectable effective rate, whereas the minimum tax looks at all tax preferences in determining whether there should be any curtailment of tax benefits. Thus, if excess charitable contributions were included as an item of tax preference in the minimum tax, the effects of this limitation would depend more on overall amount of tax benefits. In effect, the separate 50 percent limitation works as a poorly targeted minimum tax.

Reform of the 50 percent Limitation. As noted, the direct impact of the 50 percent limitation applies only to a small group of taxpayers, is modest in most cases and can even be beneficial to the taxpayer relative to outright repeal. But its direct economic effects combine with reduced incentives of the 5-year carryover for the elderly to weaken the marginal incentive for charitable contributions. This incentive is further reduced because the limitation

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[16] See, Joint Committee on Taxation (1970), p.76. The 1969 Act followed the publication of Treasury's first report on high-income taxpayers and the methods by which they reduced tax to zero. One of the severe limitations of this report was that it focused on information disclosed on tax returns, especially on itemized deductions. One of the emphases of the 1986 reform effort was on all means by which taxpayers avoided tax, including exclusions and ways in which income was mismeasured, rather than on the rather narrow category of itemized deductions.

complicates tax computations and tax planning. Its remaining justification is as a quasi-minimum tax. This justification is of questionable merit in principle. And justification aside, it is an inefficient mechanism for imposing a minimum tax in practice.

If a minimum tax approach must be maintained, we suggest two possible alternatives. The first is that the 50 percent limit apply only to gifts in excess of some minimum amount, such as $50,000 per person, indexed annually for inflation. At least this would limit its impact to taxpayers with higher incomes. The second is to provide for a set of exemptions. This would protect those who win a substantial award, or earn a large speaking fee, and desire to give that amount to charity. One doubts that the 50 percent limit was really intended to catch these particular taxpayers with some minimum-tax-type of complication. In one recent case, a teacher tried to donate the proceeds from a teaching award back to her school and got caught with a tax liability.[17]

Unintended Consequences of Outright Repeal. Although repeal of the limitation will be beneficial to many taxpayers, in some situations taxpayers with poor tax planning could be worse off. In general, although deductions used to arrive at negative adjusted *gross* income may be carried forward, no carryforward of itemized deductions is available when *taxable* income falls below zero. Thus, those with gifts in excess of 100 percent of AGI especially would be penalized. This is more likely among those wealthy enough to make contributions out of net worth. One remedy for this problem is to allow optional carryforward of negative *taxable income* that is the result of large charitable contributions. This would insure that repeal of the 50 percent limitation would benefit most taxpayers. Even here, some less-than-perfect tax planners who fail to smooth their contributions might lose the benefit of spreading deductions so as to maximize deductions against higher tax rates.

Another unintended consequence of simple repeal would be the limitation's occasional impact on the ability of taxpayers to circumvent the unrelated business income tax (UBIT) rules. Thus, there is a continuum of legal possibilities between direct and total ownership of unrelated businesses by a charity (the income from which would be subject to UBIT) and contributions of earnings by the owners of the same business to the charity (which are sheltered from tax by charitable deductions). The absence of percentage-of-income limitations (especially if extended to corporate limits, which are not examined here) would make it easier for a single taxpayer (or a small group of taxpayers) to retain title of a business and devote 100 percent of its earnings to charity and not have charitable contribution deductions limited.

3. The 30 percent Limit on Capital Gain Property: An Occasional Backstop to a Tax Preference

Under current law, in addition to the 50 percent limitation, a special 30 percent limit also applies to gifts of capital gain property to charitable organizations. In general, gains on appreciated property are treated favorably because they are not taxed until realized and, if

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[17] In this case, a teacher donated the grant for the purchase of school equipment. See Steuerle (1994) for a discussion of the bill by Senator Orrin Hatch to exclude from taxation a portion of McAuliffe grants to teachers that are not used for personal purposes.

held until death, avoid income taxation altogether. Although the estate tax may compensate for the nontaxation of unrealized income, the combined system of a tax on realized income and an estate and gift tax still favors those taxpayers who accrue capital gains until death over those with realized lifetime income. The 30 percent limitation on appreciated property might be viewed as a very imperfect backstop to the favorable treatment of accrued but unrealized income in our current system, which generally taxes realizations, not accruals, of income.

As with the 50 percent limitation, the special 30 percent capital gain limit affects only a small percentage of donors. By definition, it has no impact on donors with contributions less than 30 percent of AGI. It is also easy to avoid for those with enough cash to make contributions above the 30 percent limit up to the 50 percent limit.[18] For some wealthy donors, however, this 30 percent limit is a constraint on giving (see discussion above on findings by Odendahl, 1987).

Imperfect Backstop to Nonrecognition of Gain. The tax benefit of nonrecognition of gain increases with the size of the gain. It is interesting to note, however, that the *limit* itself applies to capital gain property, not to total capital gains. If the objective were to offset the benefits of nonrecognition, the limitation should be linked to the amount of gain. The impact of the special 30 percent limitation also grows with the size of the contribution, rather than the gain, relative to adjusted gross income.

When appreciation is a very small component of the total contribution amount, the negative effects of the 30 percent limitation can substantially offset the benefit derived from the nonrecognition of gains. (In these cases, i.e., where value is not significantly greater than basis, the taxpayer can avoid any detrimental effects of the 30 percent limit by electing to deduct only basis of property against the 50 percent limitation.) But in certain limiting cases -- i.e., where the appreciation component of donated property is large, and donors are limited by the five-year carryforward -- the detrimental impact of the loss of deductions due to the 30 percent limit can more than offset the tax benefits of nonrecognition of gain.

For the taxpayer who can hold onto assets until death, of course, the special 30 percent limit discourages the gifts of appreciated property. The taxpayer is better off giving cash of an equal value above 30 percent of AGI. To the extent that cash is given instead, there is no consequence for the government or the charity. But there is a loss of portfolio adjustment for the taxpayer. If donations of cash rather than appreciated property increase risk or decrease liquidity for such a taxpayer, the taxpayer may give less to charity. As noted, for some high-income taxpayers there is evidence that this, indeed, is the case.

Arguments for Repeal of the 30 percent Limitation. The 30 percent limitation is only binding upon certain donors of contributed property. Its impact is quite uneven relative to the

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[18] As a technical matter, the limit has an immediate impact when the 50 percent limitation cuts back deductions more than does the 30 percent limit. That is, given the presence of the 50 percent limitation and ignoring carryforward treatment, the 30 percent limitation has no effect in the current year to the extent that the taxpayer already has made contributions of cash greater than or equal to 20 percent of AGI.

size of donation, relative to AGI, and relative to the amount of unrecognized gain that might exist in the donor's portfolio. The provision adds an inordinate amount of complexity to the tax law and probably discourages giving as much by this complexity and its "signalling" effect as by any real economic effect on donors. For all these reasons, the special capital gain 30 percent limitation should be repealed. If there must be some limitation on the tax benefits provided on appreciated property, a more consistent method would be to restrict the total amount of unrecognized appreciation that can forgo tax either during life or at death, and perhaps to offset such an increase in tax with a cut in the estate tax, a proposal that is beyond the scope of this paper. We suggest in any case that it is inappropriate to try to tackle problems of a realization basis tax system by focusing solely on charitable contributions of property.

E. Special Percentage-of-Income Limits on Gifts to Private Nonoperating Foundations

More restrictive percentage-of-income limitations apply to donations to private nonoperating foundations. An overall 30 percent limitation applies to all gifts made by a taxpayer to nonoperating foundations, as well as to certain mutual-type associations with benefits for members (e.g., veterans organizations and fraternal societies). In addition, a 20 percent limitation applies to charitable contributions of appreciated property to nonoperating private foundations. The purpose of these separate limits is to provide public charities and operating foundations, respectively, a favorable differential in tax benefits relative to nonoperating foundations. As stated by the Joint Committee on Taxation:

> Because as a general rule public charities and operating foundations directly carry out charitable function and programs, expend charitable donations more promptly, and have public involvement, support, and supervision, the Congress concluded that a tax preference for contributions to public charities and operating foundations continues to be appropriate.[19]

This tilt in favor of public charities at the expense of private nonoperating foundations is an historical artifact of the perception that some nonoperating foundations seemed to be devoted inadequately to serving philanthropic purposes -- an issue that will be discussed in more detail in the next part of this paper. Here we wish to examine whether percentage-of-income limitations are appropriate mechanisms to deal with these concerns. Begin first with the issue of promptness of distributions. The 1969 Tax Reform Act dealt with this issue directly through the requirement that foundations pay out a minimum percentage of net worth each year. Percentage-of-income limits on the contributions of donors, on the other hand, have no effect on the promptness of distribution of contributions actually made.

The Joint Committee's explanation for differential treatment of private foundations[20] also makes mention of lack of broader public support. This is a more ambiguous rationale, as it is

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[19] Joint Committee on Taxation (1984), p. 667.

[20] For the rest of this section "private foundation" is used synonymously with private "nonoperating foundation." Nonoperating private foundation are those that do not directly carry on charitable activities -- that is, do not meet the pass-through requirements of the tax law. As such, they include the vast majority of grantmaking private foundations.

not defined in any precise manner. As noted previously, the tax deduction for charitable contribution might be viewed as matching grant mechanism, where the matching rate increases with the donor's tax bracket. A matching grant program funded from the expenditure side of the budget might have limited funding and receive regular review to determine how funds would be spent. Although public charities and private foundations must meet the threshold requirement of conducting activities "exclusively for charitable purposes," in the charitable contribution matching grant program it is the donor, not the government, who controls that disbursement of public funds.

The Joint Committee explanation seems to backtrack on the general rule that charitable deductions are desirable because they allow individual choice of charity, and in so doing, promote some competition in provision for the common good. Perhaps Congress considered a private foundation more likely to receive its funds from an individual, a family, or a corporation, while a public charity more likely to receive its funds mainly from a large number of public sources. After a bit of reflection, however, this distinction also breaks down. A number of public charities are also primarily dependent upon a single source or a quite small group of sources; single donors can also effectively control a set of activities within a public charity by donating money for specific purposes.

<u>Irrelevance of Rules to Stated Problems</u>. Suppose, nonetheless, that the justifications held -- that private foundations should distribute more or that they should have broader public support. Both special limits on donations to foundations as a percentage of income would still represent inappropriate ways to deal with the issues.

First, neither rule provides any guidance as to why particular dollars of contribution should be treated one way, rather than another. Why should an individual's gift of less than 30 percent of income to a foundation be treated differently from gifts of more than 30 percent of income if the activities of the foundation are by their very nature less valuable to society? Neither provision has any impact when gifts are below the stated percentages.

When the two 30 percent restrictions are used in combination, moreover, the taxpayer may effectively give 50 percent of income away in forms otherwise restricted. Thus, a taxpayer may give 30 percent of income away to a private nonoperating foundation and 20 percent away in the form of appreciated property to 50 percent limit organizations. If both activities -- capital gains gifts and donations to nonoperating foundations -- are unfavorable, why are they less unfavorable when done in combination?

Second, the rules also do nothing to penalize the activities of established foundations (with old money), for whom such rules do not apply. Thus, the percent of income limitations do not encourage payouts out of current endowments nor encourage public support of these established foundations.

Third, there seems little basis for differentiating the value of a dollar of gift according to the income of the donor. Why is the income of the donor relevant if the concern is with the distribution efforts of the foundation or the broadness of public support of the charity? For example, under current restrictions a $35,000 contribution of property by a family with $100,000 of income is not fully deductible, but a $200,000 gift is allowed for a family with annual income of $1,000,000. If it is agreed that the tax benefits associated with donations to private foundations are to be reduced to reach a given revenue target, there is no clear policy justification for doing this in a manner that penalizes certain classes of donors.

Private Benefits and Inurement. A related argument for these limits might be that, while philanthropy serves an important public purpose, there may also be private benefits present in the case of 30 percent limit organizations. Certainly the argument has merit with respect to the group of such organizations designed to provide mutual benefits, such as veterans organizations or fraternal societies. The case for including nonoperating foundations in this category, however, appears to be effectively foreclosed by the special prohibition in the 1969 Act on self-dealing by private foundations. Some donor benefits, of course, are intangible -- goodwill, respectability, increased interaction with business associates, personal satisfaction, etc. -- yet it is doubtful that Congress intended to tax these benefits. A gift to a foundation may be less beneficial to a donor than having a permanent endowment named in one's honor at a university or health institution. Contributions to an organization to which one belongs, such as a church, or where one works, such as a hospital, are even more likely to be returned partially to an individual in the form of services or income. There are many sources of recognition or well-being -- work environment, friendship, titles -- but the tax system was never intended to tax these additional benefits over and above income.

Arguments for Repeal of Separate Limits on Gifts to Private Nonoperating Foundations. From a policy perspective, the limits on gifts to private foundations are distractions from two issues: whether the activities of some charities financed through matching grants need to be restricted, and whether appreciated property should be subjected to some minimum tax.

The latter issue we discussed above with respect to the special 30 percent limit on capital gain property. Congress recently decided that a minimum tax on gifts of appreciated property to charity was inappropriate, especially as long as gifts of appreciated property to heirs of one's estate went untaxed. The distinction between the 30 percent special capital gain limit and the 20 percent limit on capital gain gifts to foundations, moreover, is small enough that it seems hardly worthwhile, given the added complexity of the distinction.

As for the activities of foundations and other charities, we doubt seriously that the problems raised in the late 1960s are the same as those that concern Congress and the public today. If some charities are viewed as inferior in their activities, then the principal issue becomes how to how to regulate or restrict further the less valuable activities of the relevant charities -- no matter in which part of the charitable sector they fall. And if certain types of foundations were still found abusive, then those are the ones that should be limited -- not all foundations. In effect, the limits should apply to whatever abuse is perceived, not to a *category* of organization.

Finally, we again note that the principal objection to nonoperating foundations -- that they were retaining too much of their earnings and serving philanthropic purposes inadequately -- was resolved through a more direct provision: the adoption of a minimum payout percentage. Limitations on giving are no substitution for determining the appropriate payout rate.[21] The

[21] See Steuerle (1977) for a discussion of determining standards for that rate.

issue of control of corporations, in turn, was handled directly through specific limitation on the "excess business holdings" of private foundations. The IRS has found no evidence that these special private foundation regulatory measures have failed to accomplish their objectives. Even if there were such evidence, it would imply that the regulatory prohibitions themselves should be reformed. There is no reason, however, why they should be supplemented by so indirect a mechanism as the 30 percent limit on donations to nonoperating foundations or the 20 percent limit on gifts of appreciated property to nonoperating foundations.

PART II. VALUATION OF APPRECIATED PROPERTY DONATED TO PRIVATE FOUNDATIONS

A. INTRODUCTION

All the limitations on charitable giving examined in Part I apply either at upper-income levels or when giving is above certain percentage of income. There is one limit, however, that applies regardless of income or percentage of income given away. For gifts of appreciated property to private foundations,[22] market value must be reduced by the amount of long-term capital gain, regardless of income or percentage of income given away. That is, a donor may deduct only his basis. For gifts to all other charities, contributions of appreciated property may be deducted at their full market value. Thus, the tax laws governing deductions for charitable contributions leave private foundations at a disadvantage relative to public charities.

In this section, we shall see that legislation enacted in 1969 adopted a variety of specific rules designed to eliminate the real and perceived abuses by private foundation. This legislation came in the wake of more than a decade of highly adverse publicity about abuses then existing among a significant minority of private foundations. Studies indicate that the anti-abuse rules enacted as part of the 1969 legislation have worked well to correct those problems. But experience with the original 1969 limit on gifts of appreciated property and a 1984 amendment of it suggest that this particular limit does nothing to correct abuse, but does have a very strong influence on donors' decisions about their charitable giving. Thus, serious consideration should be given to eliminating the 1969 basis limitation on deductions for gifts to private foundations. Restoration of the 1984 amendment allowing market value deductions for contributions of publicly traded stock would go a long way to effecting this result.

B. THE ORIGIN OF THE BASIS LIMITATION ON DEDUCTIONS

Private foundations became the object of intense congressional and increasingly public criticism during the decade of the 1960's. Beginning in 1961, Congressman Wright Patman held a series of investigations which resulted in the publication, between 1962 and 1969, of eight reports highly critical of foundations on a number of scores.[23] In 1964, the Senate Finance Committee requested a major review of private foundations by the Treasury Department. Based on a special IRS review of a stratified sample of approximately 1300 foundations, analysis of all available economic data concerning foundations, regular meetings with groups of independent experts on foundations, and study of a variety of other information, the resulting 1965 Treasury Report was a detailed, thorough, and balanced examination of the subject.[24] Although supportive of private foundations in general, the report identified a series

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[22] Here again, the terms "private foundation" and "foundation" refer to nonoperating private foundations.

[23] The level of concern at the time can be seen in the chapter titles of report U.S. Congress, House Select Committee on Small Business (1968), e.g., chapter III, "They can almost take it with them;" chapter VIII, "The United State Treasury: The toothless watchdog."

[24] See U.S. Congress, Senate Committee on Finance (1965).

of serious abuses by a minority of foundations, including self-dealing, family use of foundations to control businesses, and delay in benefits provided to operating charities. And it made specific legislative recommendations to deal with them. The basic approach advocated by the report was to address existing abuses through targeted legislation. The report rejected broader restrictions on the creation, funding, or longevity of foundations.

In 1969, when Congress turned to tax reform in general and foundations in particular, it enacted stringent measures to cope with the specific abuses on which the Treasury Report had focused. Among these were a series of excise tax penalties imposed on self-dealing transactions, on excess business holdings, and on failures to distribute a specified percentage of foundation asset value annually to support charitable activities.

By 1969, however, the negative publicity about private foundations had generated considerable reaction in Congress, as reflected in the hearings on foundations held by the Ways and Means Committee early that year.[25] As one consequence of the intensified atmosphere, the committee (and, ultimately, Congress) responded with several measures well beyond the specifically targeted Treasury recommendations. One was the additional provision under consideration here, limiting the charitable deduction for gifts of appreciated property to private foundations to the donor's basis.

C. Success of the 1969 Legislation and the Market Value Deduction for Publicly Traded Stock

The 1969 legislation was remarkably successful in controlling the abuses of foundations first identified in the Treasury report. In the five years succeeding the 1969 legislation, the IRS audited virtually every foundation in the country and concluded that there was "a high level of compliance" with the new provisions.[26] Since the conclusion of that project, the IRS has maintained an active foundation audit program, and it has consistently reported similarly high rates of compliance.[27] As a result, the IRS has significantly reduced its audits of private foundations--from 1600 in 1990 to 462 in 1994.[28]

As noted, this success was due to the anti-abuse restrictions of the 1969 legislation, not to limits on deductions (which did not apply to established foundations, anyway). In 1984, therefore, Congress moved to narrow substantially the differences in the deductibility of gifts to private foundations and public charities. Most importantly, Congress enacted a provision

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[25] See generally, U.S. Congress, House Ways and Means Committee (1969).

[26] See Owens, Assistant Commissioner of Internal Revenue for Employee Plans and Exempt Organizations (1963).

[27] See Internal Revenue Service (1990). See also the remarks of IRS Assistant Commissioner Brauer (1990).

[28] Figures, reported by Marc Owens of the IRS, and recorded by John Edie of the Council on Foundations, at a meeting of the Subcommittee on Private Foundations, Exempt Organizations Committee, American Bar Association Tax Section in Los Angeles on January 27, 1995.

which, for the following ten years, generally would allow a deduction at market value for gifts of publicly traded stock to private foundations.[29] By limiting the availability of the full value deduction to stock traded on an established securities market, Congress avoided particular concerns about the valuation of donated property (such as artwork or real estate) which had motivated the adoption of the basis limitation in 1969.[30]

D. EFFECT OF BASIS LIMITATION ON PRIVATE FOUNDATIONS

Appreciated property, particularly appreciated stock, has historically been -- by a considerable margin -- the most important source of contributions to private foundations. According to the Peterson Commission, prior to the 1969 legislation 78 percent of contributions received by private foundations with assets of between $10 and $100 million dollars were appreciated intangible property.[31] The figure for foundations with assets over $100 million was 88 percent. Eliminating the market value deduction for gifts of this critically important category of property, therefore, would have a dramatic effect on private foundations. Indeed, a survey conducted prior to the 1969 Act indicated that large charitable donors viewed the basis limitation as the provision that would have the greatest negative impact on their future contributions to foundations.[32]

The experience of practitioners in the foundation field confirmed these predictions. There is virtually uniform agreement that *non-bequest* giving to private foundations dropped dramatically after 1969.[33] The effects of this decrease can be seen in the reduction in the number of foundations created soon thereafter. During the 1970's, only 255 new foundations with assets greater than $1 million were created -- as compared with 759 during the 1960's.[34] Even the 255 figure probably understates the impact of the 1969 limitation on contributions to foundations during donors' lives.[35] When Congress restored the incentive to

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[29] At the same time, Congress extended the 5-year carryforward rule, already applicable to contributions to public charities, to private foundations, and it raised the percentage limitation on gifts of cash and non-appreciated property to 30 percent.

[30] See U.S. Congress, Joint Committee on Taxation (1969).

[31] Commission on Foundations and Private Philanthropy (1969).

[32] Commission on Foundation and Private Philanthropy (1969), p. 6171.

[33] Interview with Thomas A. Troyer, Caplin & Drysdale, Washington, DC, who participated in the 1964-65 Treasury study and since 1969 has had an active foundation practice (1995).

[34] Council on Foundations (1983).

[35] The 255 total does not differentiate between foundations created at death, through the estate tax deduction, and those created by lifetime contributions. The estate tax deduction was unaffected by the 1969 basis limitation, continuing to allow full value deductions for bequests to foundations after 1969. Further, most testamentary giving during the 1970's presumably took place under wills and trusts drafted before 1969, so that the 1969 foundation legislation had no

give appreciated stock to private foundations in 1984, there were marked increases in the number of foundations created.[36]

Anecdotal information implies that the recent loss of full deductibility could again have a dramatic impact on the formation of new foundations. In the year before the full value deduction expired, the Council on Foundations received hundreds of communications from potential donors, tax planners, attorneys, and accountants who were gravely concerned about the expiration of that section.[37] It has been many years since a provision of the federal tax laws governing private foundations has been the object of concern of this magnitude.

E. Private Foundations and Other Charities

The 1965 Treasury Report concluded that private foundations play a special and important role in the private philanthropy. The Report cited both the independence and flexibility of foundations as sources of their unique ability to expand the range of possible solutions to social needs.

> Available even to those of relatively restricted means, they enable individuals or small groups to establish new charitable endeavors and to express their own bents, concerns, and experience. In doing so, they enrich the pluralism of our social order. Equally important, because their funds are frequently free of commitment to specific operating programs, they can shift the focus of their interest and their financial support from one charitable area to another. They can, hence, constitute a powerful instrument for evolution, growth, and improvement in the shape and direction of charity."[38]

The restoration of unequal treatment of foundations for corporate stock donations is the indirect result of the expiration of a ten-year provision adopted in 1984, not any new concern about abuses within that sector. Indeed, Congress' recent concerns have been centered on abusive conduct by *public* charities. Beginning with the media coverage of the United Way scandal and the tax problems of televangelists and certain hospitals, this concern culminated

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bearing on it whatever. Hence, it seems reasonable to conclude that most of the 255 foundations were created without regard to the 1969 basis limitation.

[36] Foundation Center (1994). After 1985, however, the effects of the 1984 amendment were offset for certain high-income taxpayers by changes in the alternative minimum tax. Between 1985 and 1993, taxpayers subject to the AMT had to reduce the amount of any charitable deduction taken for a contribution of long-term capital gain property by the amount by which the deduction exceeded basis. Thus, for an important category of potential donors, the increased incentive for giving created by the fair market value deduction for publicly traded stock was neutralized by the AMT. Nevertheless, the creation rate for private foundations during the later half of the 1980's remained substantially above that for any year during the 1970's.

[37] Interview with John Edie, Vice President and General Counsel of the Council on Foundations (1995).

[38] Id. at 5.

in hearings by the Oversight Subcommittee of the House Ways and Means Committee in 1993 and 1994.[39] After the 1993 hearings, Representative Stark introduced the "Exempt Organizations Reform Act of 1993," which would have imposed penalty taxes on private inurement and self-dealing transactions by public charities.[40] The need for precluding the use of public charities for private ends was echoed in the Treasury Department's 1994 proposal to the Oversight Committee that a penalty tax be imposed on any "excess benefit" paid by a public charity to its officers, directors, trustees, or any other individuals with the ability to exercise substantial influence over it.[41] The Oversight Subcommittee subsequently approved legislation modeled closely on the Treasury recommendations, and the House passed it.[42]

The findings by both congressional leaders and the Treasury Department that some public charities are misusing the benefits of their tax exempt status -- coupled with the continuing evidence that private foundations are complying with the rigorous anti-abuse rules governing them -- strongly suggests that the basis limitation on gifts to foundations is no longer justified.

F. CONCLUSION

The disincentive to give to private foundations created by the 1969 Act's basis limitation appears to be a residuum of legislation enacted in response to a situation which no longer exists. In light of the successful functioning of the 1969 anti-abuse restrictions on foundations, it lacks current justification. Restoration of the market value deduction for gifts of publicly traded stock to private foundations would provide likely donors greater opportunity to carry on their charitable giving free from a tax constraint which has long since been overtaken by changes in the philanthropic world.

In both this and the prior section, we questioned the unequal treatment of private foundations vis-à-vis public charities. To the extent there are abuses, private foundations--if anything--appear to be less suspect than public charities. As noted in Part I, to the extent that Congress wishes to deal with the deferral of accrued capital gains or their exclusion from taxation at death, it should do so in a uniform and consistent manner, not merely applying special rules to foundations. And to the extent there are abuses in the charitable sector that warrant action, direct remedies--such as strengthening anti-abuse rules--would clearly be more appropriate than across-the-board penalties that are unrelated to abuse by particular entities.

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39 U.S. Congress, House Ways and Means Committee (1993) and (1994b).

40 H.R. 3697, 103rd Cong., 1st Sess. (1993).

41 Statement of Leslie Samuels, Assistant Secretary, Department of Treasury, Subcommittee on Oversight, House Ways and Means Committee, 103rd Cong., 2nd Sess, (1994).

42 U.S. Congress, House Ways and Means Committee (1994a).

PART III. ALLOWING CHARITABLE GIVING UNTIL APRIL 15[43]

A. INTRODUCTION

If the charitable deduction is meant to provide some incentive for charitable giving, we should consider how to design it so that it achieves this purpose in the most effective manner. One means would be to allow individuals to take deductions for charitable contributions up to the time they file their income tax returns, or until April 15, whichever comes first -- unlike the requirement under current law, which has a deadline of the end of the calendar year preceding the April 15 filing deadline.

This proposal would provide little change in the pure economic incentive for charitable contributions. Each dollar of contribution would receive the same Federal subsidy at the taxpayer's statutory tax rate of 15, 28, 39.6 or other tax rate. The case for allowing a deduction up until time of filing is related mainly to planning and psychological considerations.

B. COMPARISON TO INDIVIDUAL RETIREMENT ACCOUNTS AND KEOGH PLANS

Under current law, deductions for charitable contributions to individual retirement accounts (IRAs) and self-employed retirement plans (Keogh Plans) are allowed until filing time. For the 1984 taxable year, 45 percent of IRA contributions were actually made in 1985.[44] Our proposal simply extends similar treatment to charitable contributions.

Why are retirement deductions allowed up to the time of filing tax returns? Mainly for planning purposes. Many taxpayers take special note of allowable deductions when they fill out their returns. Deductions are limited in relationship to income, but the taxpayer seldom knows last year's total income until calculations are made during filing season. Finally, from a psychological standpoint, it is at tax filing time that tax burdens are most apparent, benefits from deductions appear most real, and antipathy toward the tax system is strongest.

Similar arguments can be made with equal force for extending the charitable deduction. In particular, allowing a charitable deduction up to the time of tax filing would (1) advertise the value of the incentive much better, (2) help taxpayer planning, and (3) provide a special incentive for those who find that last minute payment of taxes or tax penalties is most onerous.

C. THE TIMING OF ADVERTISING

Suppose a private company is attempting to promote its products. One favorable time for advertising is when people engage in activity closely associated with the product. For

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[43] Much of the material for this section is taken from various "Economic Perspective" columns by Eugene Steuerle for *Tax Notes* Magazine.

[44] See Summers (1986). We are grateful to Edith Brashires of the U.S. Treasury Department for this reference.

instance, advertisers will often attach coupons to their merchandise and use fancy packaging to catch our attention as we make a purchase. Since government is effectively providing coupons or matching grants for charitable deductions, why should not it engage in a similar advertising or packaging campaign?

Under current law, the government does advertise its product at tax filing time, but refuses to let the taxpayer fully use the coupon or matching grant on that year's return. Moreover, the price incentive for next year is not known until the new filing season has begun. This is hardly a well-designed advertising campaign.

D. An Aid to Planning and Avoidance of Tax Penalties

Tax filing represents a unique moment when many households do their annual budget calculations, see the amount they have earned over the past year, and, in some instances, determine just what they have done with their money, especially with respect to deductible expenses. It is an ideal planning period in which taxpayers can assess how much they can afford in charitable contributions. Given the tendencies of the individual to underestimate income and overstate past generosity, the tax filing period is a time when taxpayers might call themselves to task on whether they have given a reasonable percentage of income to charity.

For a small group of high-income contributors, we have already noted evidence that planning practices are closely related to calculations that cannot be made until the end of the year. That is, some try to give up to the 50 percent overall limitation, or the 30 percent maximum for capital gains property. With uncertainty about what that maximum is, however, they are quite likely to play safe and underestimate. If they want to give 50 percent of their income to charity, it is likely that they give 40 or 45 percent so as to avoid giving in excess of the limit.

Finally, allowing charitable contributions up to filing time would allow some taxpayers to avoid penalties for underpayment of taxes during the year. Many taxpayers find penalties especially onerous, as these fines work against their self-image as honest taxpayers. It would not be surprising if taxpayers would be quite willing to pay $1,500 to charity, for instance, to avoid a $500 tax penalty. The net gain to society is liable to be greater than the loss in penalty and the matching grant. In any case, the goal of tax penalties is not to raise revenues directly but to encourage compliance with the laws. An extended charitable deduction period would simply make that compliance easier, and yield greater goodwill toward IRS as an extra benefit.

E. Some Possible Objections

There are two possible objections to this proposal. The first is related to the charitable deduction itself, the second to complexity.

<u>The Deduction</u>. The first objection is that any increase in charitable giving would reduce taxes. Charitable activity would partially substitute for public sector activity. This objection is not really to the proposal, but to the deduction itself. If there are abuses of the deduction -- or if Congress deems some charities to be less valuable than others -- there are mechanisms for dealing with those issues. For instance, qualification rules can be tightened. Limiting

deductibility to the end of the calendar year is a rather blunt instrument, since it applies to all charitable activity -- including activity that Congress wants to favor.

Complexity. A more serious concern is potential complexity. Extending the deduction period, however, would add little to complexity -- and for many taxpayers would greatly simplify tax planning. Few argue, for instance, that it would be simpler if deductions for IRAs or Keogh plans were allowed only until December 31. Many taxpayers prefer the later deduction so that they can relate it to the amount of income claimed on returns. If there is any additional complexity, it is mainly that the taxpayer must designate the filing year for which to claim charitable contributions taken between January 1 and filing time. This is not the type of complexity to which taxpayers are liable to object.

Objections still might be raised if the administrative burden on the IRS were to increase substantially. But that is not likely the case. Indeed, this provision were simply grafted onto current law, the itemized deduction schedule would look almost identical. A few extra lines of instruction would be required. Audit, admittedly, becomes more complex, as the auditor must make some additional effort to insure that deductions are not declared twice. If IRS objections were strenuous enough, one might restrict the extended filing period to cases where the taxpayer and the charity agreed to file a form indicating the size of the contribution to the IRS. This would shift any burden from additional complexity to that part of the charitable sector wishing to participate, and might actually improve compliance.

PART IV. THE EXCISE TAX ON INVESTMENT INCOME OF PRIVATE FOUNDATIONS

A. INTRODUCTION

Although public charities and private foundations both enjoy the benefits of deductibility of contributions paid to them and the related tax exemption on their earnings, many aspects of tax law penalize private foundations vis-WP-vis public charities. Some of these have been discussed in previous parts of the report. Here we discuss another of those penalties: the excise tax on the net investment income of certain private foundations. The tax was first imposed by the Tax Reform Act of 1969 at a rate of four percent on all foundations.[45] Net investment income includes interest, dividends, and net capital gains and is reduced by expenses incurred to earn this income. The tax rate was lowered from four to two percent in 1978. The tax came into its current form with the passage of the Deficit Reduction Act of 1984.

As a result of the 1984 legislation, operating foundations that were considered to have substantial public involvement and public control were exempt from the tax. More generally, relief was provided under the excise tax by lowering the rate of tax from two percent to one percent for any foundation that increases distributions (relative to a moving average of the prior five years) by an amount equal to or greater than the amount of excise tax saved.

> [T]he Congress concluded that the rate of section 4940 excise tax should be reduced from two percent to one percent, but only where there is an equivalent increase in the foundation's qualifying distributions for charitable proposes. In other words, the Congress determined that the tax reduction is to be available only where the foundation makes an "extra" charitable effort equivalent to the decrease in tax revenues.[46]

The current excise tax can be thought of as a combination of two taxes. First, there is a one percent tax for being a private foundation. Second, there is an additional one percent tax on those foundations that do not maintain their rate of giving (including the tax savings), especially relative to levels prior to enactment of this provision. As shown below, the current formula often fails to achieve its stated intent.

B. THE EXCISE TAX AS AUDIT FEE

The excise tax was first enacted in 1969 with a uniform rate of four percent. Although it can be examined as a minimum payout provision or as a partial repeal of exemption, its stated purpose was to pay for administration of tax law relating to exempt organizations. Furthermore -- notwithstanding the nature of the excise tax as a very partial repeal of tax

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[45] A concise and readable legislative history of this provision in the 1969 Act is found in Cohen (1994), pp. 398-400.

[46] U.S. Congress, Joint Committee on Taxation, 1984, pp. 672-3.

exemption -- Congress explicitly rejected the notion that income of private foundations should be subject to income tax:

> The Congress concluded that private foundations should share some of the burden of the cost of government, especially for the more extensive and vigorous enforcement of the tax laws relating to exempt organizations.
>
> However, the Congress believes that private foundations should continue to be exempt from income tax. Accordingly, the Act casts the charge or audit fee for private foundations in the form of an excise tax with respect to the carrying on of the organization's activities.[47]

Congress reiterated this reasoning in its justification to reduce the excise tax rate from four to two percent in 1978, and again in 1984 when it provided a rate of one percent "where foundations make an 'extra' charitable effort" in the form of increased distributions. Although at each of these three junctures Congress has utilized this audit fee principle, revenue raised by the tax is not earmarked for administrative costs. Nor does it even roughly equal administrative costs.

Critique of the Audit-Fee Justification. Despite the loose application of the user fee principle by Congress to calibrate the tax to administrative costs, practice has never really followed theory. First of all, the targeted amount of revenue is the cost of administration for all exempt organizations. *Private foundations, therefore, have been asked to pay to the cost of administering the application of tax laws not just to themselves, but to public charities, social welfare organizations, and pension plans.* Although in practice user fees often involve cross subsidization between different classes of payors, it is more than a stretch to assume that private foundations -- which collectively constitute a relatively small portion of the tax-exempt sector (whether measured in terms of number of organizations, assets, or revenues) -- should be asked to bear the entire burden. Fairness and common sense dictate that a user fee to be paid by private foundations be related mainly to the costs that private foundations generate.

In a similar manner, if all business and charitable entities were required to share in the cost of administration, all other exempt organizations (including corporations and other businesses that do not pay tax) should pay user fees. Finally, the tax base chosen does not seem appropriate as a proxy for user cost. Investment income is not a good measure of "the carrying on of the organization's activities" or of the cost of administration. Indeed, reform of the minimum payout requirements for foundations required the removal of realized investment income from the formula. Some foundations received their income in the form of interest and dividends, others as unrealized capital gains. Hence, the minimum payout formula was eventually revised and based only on net worth.

Earmarking. If Congress truly wished to implement the audit fee principle, the tax on investment income should be earmarked for administration of the tax laws. Such a linking of excise tax revenue and costs of administration could be achieved in either of two ways. First, the tax rate could be adjusted to the costs of administration. Alternatively, the funds available

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[47] U.S. Congress, Joint Committee on Taxation, *General Explanation of the Deficit Reduction Act of 1969.*

for administration could be tied to the rate. In the former case, the IRS would be free to determine whatever level of administration it thought appropriate and charge for it. In the latter case, a rate could be selected for any of a variety of reasons, and then the amount raised would determine what was spent.[48]

Complete earmarking is not the answer, however, because it could be inefficient and set up its own perverse incentives. For example, IRS should not have an incentive to spend whatever it wants to audit tax-exempt organizations, and then charge whatever fee necessary to cover those costs. Nor should IRS have an incentive to spend exactly what is legislated through some earmarked source if such spending would provide greater social benefit elsewhere. In theory, Congress should decide how much it believes to be appropriate to spend on audit activities, taking into account the loss of other productive efforts in the economy, and weighing all social costs and benefits. Only then, if a designated tax must be used, should the tax be determined by that optimal level of audit and review. This amount would vary over time. When the foundation sector was viewed as relatively compliant, for instance, audit efforts and the amount of tax collections should fall.

Note that if the tax is meant to help audit the charitable sector, a strong case might be made to strengthen the monitoring of this sector primarily by providing better disclosure and more information to the public. This could be achieved by devoting some of those funds toward improving the statistics on and public availability of returns filed by foundations and other charities. Although technically these returns are already open to the public, they are often poorly filed and cannot be well monitored by the limited staff at IRS. Public scrutiny of these organizations may be more likely to encourage compliance and appropriate charitable activity than simply spending the same money to expanding the very limited audit efforts by IRS.

If the audit argument is followed to its logical conclusion, the excise tax or audit fee should vary with degree of difficulty of audit or with probability of noncompliance. For instance, foundations with undiversified portfolios might be charged a higher fee; foundations that were simply grant-making and paid no staff might be charged a lower fee. An even more direct method would be to charge noncompliant foundations a penalty sufficient to cover most or all the cost of auditing the sector.

C. The Excise Tax As an Indirect Payout Requirement

From a purely economic standpoint, the subsidy provided for portfolio investment by charities such as educational institutions, hospitals, and private foundations is equivalent to an exemption of that income if earned by the taxpayer, then given to a charity. Allowance of this exemption to continue within the organization, along with deferral of charitable activity, implies that future expenditures are valued as much as current ones -- or that government views society as sharing from the larger future charitable sector that is likely to result from retention of net worth.

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[48] In either case, to allow time for computation, there would have to some lag between budgeting administrative costs and setting the rate of tax. Furthermore, in practice, moving averages would likely be employed in order to smooth out any spikes in funding.

By the same token, tax deductions for charitable contributions are the economic equivalent of matching grants made immediately. Government might therefore wish to insure that these matching grants are spent on some ratable basis, so that the value of the contributions might inure partly to the same public that made the matching grants. Government might also desire to deny to a foundation with no new contributions the ability to grow perpetually in power and influence at a rate faster than the rate of growth of the economy.[49]

Legislative history indicates that Congress attempted to achieve a balance in setting its actual distribution rule. While it prevented distributions from falling below a certain minimum level, it also rejected proposals that would significantly reduce the real size of the investment portfolios of existing private foundations. The distribution requirements of current law generally are the mechanism used to deal with the problem of foundations retaining too high a portion of their income, and the required rate of distribution was set at a level near to the expected real rate of return on a foundation portfolio of assets.

The excise tax on investment income at first appears to be devoted to this purpose also. In practice, however, it fails at this mission as well. First, the tax is creditable against the minimum charitable payout, thereby providing no new incentive in the current period, and reducing net charitable assets to be given away in the long run. Second, its attempt to provide a disincentive to reduce payout below recent experience fails in actual operation, as we shall see in Section D.

D. The Operation of the Two-Percent and One-Percent Tax Rates on Investment Income

The stated intent of the distinction between a one- and two-percent rate of tax on investment income was to prevent disbursements by foundations from falling.[50] The mechanism is unduly complicated and in some cases may even provide strong incentives for foundations to reduce distributions. In all cases, increased tax planning is required. The optimal tax strategy for a private foundation is to choose a target rate of disbursement and maintain that rate in all future years. As noted by Troyer (1987), in practice large foundations have found it worthwhile to perform the planning necessary to minimize excise taxes. However, for a number of smaller foundations, the administrative and planning costs are often excessive relative to the saving.

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[49] See Steuerle (1977).

[50] As noted by John Edie of the Council on Foundations, Rep. Barber Conable (R-NY) pushed for adoption of straightforward reduction in the excise tax rate from two to one percent during a closed markup of the Ways and Means Committee. Conable's proposal met opposition arguments that savings from such a rate reduction should not go into the existing endowment of the foundation. Hence, he suggested the current mechanism whereby foundations had to increase their current rates of distribution by the amount of any excise tax reduction in order to receive the tax reduction.

Tax Benefits for Distributions above a Moving Base. The mechanism for determining qualification for the one percent rate shares some similarities with the structure of the incremental research tax credit before its reformulation in 1990. The weaknesses of that moving-base incentive structure are well documented.[51] The major problem was that any additions to qualified activity in the current year only reduced tax benefits in all the following years where current year activities entered the base amount. The net result was an effective benefit far below that suggested by the statutory rate. The other major problem with the moving base incremental credit was that once a firm found itself with expenditures below the moving base amount in the current year, it had large incentives to reduce its current year's expenditures.

Problems with the Mechanism to Qualify for the One-Percent Rate. There are several differences between the moving base structure of the pre-1990 research tax credit and the qualification mechanism for a preferential rate on investment income. While some differences are not of major importance, others make the investment income excise tax an incentive inferior even to the old research credit incentive mechanism.[52] One important difference converts the mechanism from a mild incentive to increase activity to a *tax disincentive for increasing payment in a given year.* Under the old research credit, each dollar of research credit over the base was generally rewarded with increasing credits, so generally there was always an incentive for increasing qualified expenditures. Under the qualification rules, once the private foundation exceeds its base amount in the current year, it is eligible for the one percent rate and can do no better. In fact, it can only hurt itself by increasing the base over which future disbursement must exceed in order to receive the credit. Thus, over time the one percent rate does not provide an incentive, but an actual disincentive, for increasing disbursement in any substantial way. As noted above, the optimal tax strategy is to lock into a target distribution rate and try to get as close as possible to but never below that percentage in every year.

Large Foundations' Distribution Rate is Close to Five Percent. Data from the Statistics of Income Division of the IRS show that the average distribution rate of large foundations is remarkably close to five percent of assets. This is the minimum disbursement requirement under current law. Because this consistent with tax minimizing behavior, such behavior is not unexpected. Even if the primary cause is the inclination on the part of foundations to maintain their endowments over time, the operation of the excise tax provides an additional tax incentive for holding distribution close to a rate of five percent once it has been there for a few years.

E. Alternative Methods of Regulating Distributions

If Congress truly desires to regulate distributions by private foundations, it already has a sound mechanism in place under current law -- the minimum distribution requirements. Data

[51] See, for example, U.S. Congress, Joint Committee on Taxation, 1992, pp. 59-68.

[52] One difference is that the research credit had a three-year moving base, while qualification rules have a five-year moving base. Another is that the research credit's base was a weighted average of prior year expenditures while the qualification base is a simple arithmetic average.

indicate that large foundations (which account for the bulk of private foundation assets) are distributing very close to the five-percent minimum allowed under current law, Congress, therefore, has apparently met the explicit distribution goal it has set. The excise tax mechanism may have even reduced the willingness of foundations to pay out an increased amount in any particular year, even when the needs of the population being served by the foundation are unusually high.

Most large foundations hold a large percentage of their assets in the form of corporate stock. Hence they often tend to realize investment income of less than five percent of net worth. This implies an excise tax rate of only about 0.10 percent of net worth at the two percent rate and 0.05 percent of net worth at the one percent rate. If one of the goals of the reduction in the excise tax rate from two percent to one percent is as stated -- to encourage foundations to add the difference to their payout -- it would be equivalent to raising the foundation payout rate to 5.05 percent. We doubt that a change of this magnitude is worth the effort, but at least it is much more direct than the excise tax adjustment method.

Congress apparently also wanted to maintain the overall payout rates of foundations paying more than five percent. Thus, the higher level of excise tax also applies to those foundations that reduce their payouts below their historical payout rates -- regardless of the initial level. Suppose that, prior to enactment, a foundation's payout rate was six percent and this prior rate was used to established the threshold for tax relief. This foundation would be penalized as it reduced its payout rate from 6.0 percent to 5.8 percent, even though the foundation that never pays more than 5.0 percent never faces the same penalty. The inequity of requiring a different payout rate across all foundations is apparent. As years have passed, moreover, any temporary gains achieved by this "maintenance of effort" requirement have probably dissipated, and the net impact of the incentive is now to discourage foundations from temporarily raising their payout rate.

F. REFORM OF THE EXCISE TAX INCENTIVE

Congress could easily reform the current moving base structure and replace with a fixed annual base (e.g., a fixed percentage of income or net worth). The simplest base would be the minimum payout requirement already applying to foundations. A simple tax rate would apply to those foundations with payouts at or above the base and a higher rate to those below the base. This would provide significant simplification, not only in tax planning but also in the design of the tax form, 990PF.

This straightforward approach would effectively remove the penalty tax for distributions below a moving base. A rate could be chosen to achieve revenue neutrality if the only goal was simplification and Congress continued to violate the rule that the tax was meant merely to pay for the audit of foundations themselves. A rate of one percent of income, of course, still would raise more than required as an audit fee, and an even lower rate can be justified on those grounds.

Finally, whatever the revenue target, Congress could set the rate as a percentage of foundation net worth. This was the type of proposal originally passed in the Senate in 1969, but not accepted in Conference.[53] This would provide greater equity among foundations and remove incentives to realize or not realize capital gains. A similar logic led to the abandonment of determining payout rates on the basis of investment income.

[53] Treasury objected to annual valuations required by such a tax, and the Treasury view prevailed in conference. See Cohen (1994). In later years, however, Treasury would accept net worth by itself (without an income test) as the basis for determining the base for minimum payout requirements.

PART V. POSSIBLE METHODS OF IMPROVING DISCLOSURE BY CHARITABLE ORGANIZATIONS

A. INTRODUCTION

Because of the public nature of charities, their tax returns are open to the public. Continuing concern is voiced, however, that disclosure is inadequate and, in some cases, cumbersome. With modern computers and data processing, moreover, organizations such as the National Center on Charitable Statistics play larger intermediary roles as transcribers and assemblers of the data made available by charities on their tax returns. Reporting and disclosure requirements, therefore, can be expected to evolve continually to address both new opportunities and old problems. Legislation was approved by the House of Representatives in 1994, for instance, that would increase public disclosure requirements of charitable organizations. Among the new requirements would be that exempt organizations furnish copies of (rather than just access to) information returns and applications for exemption, that fundraising solicitations explain the availability of these documents, and that information related to penalty excise taxes be included on annual information returns. The legislation also included increased penalties on exempt organizations that fail to allow public inspection and fail to file timely returns.

Increased availability of information about the finances and activities of tax exempt organizations can serve a multitude of purposes. This information helps:

1. donors and potential donors -- to evaluate the worthiness of the tax exempt organizations;

2. the Internal Revenue Service -- to enforce the tax laws;

3. Congress -- to evaluate and revise laws that pertain to charitable organizations;

4. State Attorneys General and other law enforcement officials -- to guard against fraud and abuse;

5. the general public, including the press -- to scrutinize the activities of charitable organizations as well as to guard against potential abuses and to provide the public with information about activities that accomplish tax exempt purposes;

6. the tax-exempt sector itself -- to learn from each other and perhaps even to induce higher contributions through improvements brought about by increased scrutiny, and removal of abuse situations.

At the same time, the potential benefits of increased disclosure must be weighed against costs. First, there are the direct costs of collecting, organizing, storing, and making information available. Second, there are issues of privacy and security. Third, there are potential congestion costs if so much information is provided as to be incomprehensible to most users. It is not only the amount of information that matters, but also the manner which it is presented. To the extent possible, information should be made available in a timely manner, in a form that is readily understandable, and at a convenient time and place. While in many cases information will be most useful when presented on a return-by-return basis, in some circumstances information will be more useful when many returns are combined into data sets that may be analyzed statistically.

In addition to the proposals discussed below, we also examined requirements for further disclosure by charities when fundraising. For example, charities might be required to report expenditures for private fundraising (which can be so high that little is left for charitable activities), the percentage of gross income used in fundraising or the percentage paid out in a year,[54] salaries of top personnel, or whether the fundraiser is an insider. So far, the design of a general disclosure rule, appropriate in all circumstances, proved elusive.[55] But in our judgment, public information is potentially the most powerful regulator of practices, and still could be enhanced considerably through reform in form design and accessibility of the type examined below.

These proposals came to our attention from a variety of sources. All are intended to simplify or reform the disclosure requirements of charitable organizations.

B. POSSIBLE PROPOSALS TO IMPROVE DISCLOSURE

1. Streamline the Annual Information Returns Filed by Charities

By far the most important source of public information about charitable organizations is the Form 990 and Form 990PF annual information returns (referred to hereafter as Forms 990). Since 1942, the filing of annual information return has been a requirement for certain tax exempt organizations. Included on this return are financial information (such as gross income, total contributions, expenses, and distributions for exempt activities) and the names and addresses of managers, highly compensated employees, and substantial contributors, as well as the amounts paid to mangers and highly compensated employees. Under current law, all public charities must have available at their business offices their most recently filed Forms 990 as well as their Forms 990 from the prior two years. In addition to these three Forms 990, each organization must also have available for inspection its exemption application (Form 1023) and any document submitted to the IRS in support of that application. Over the years, the amount of information to be included on these returns by charitable organizations has increased, as have the penalties for failure to file and accurately complete these returns.

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[54] See H.R. 10922 of the 94th Congress and the accompanying report U.S. Congress, 1976. Also, see draft legislation, "Truth in Fundraising Act of 1989," for Senator Howard Metzenbaum.

[55] Some object that this would impinge on the First Amendment rights of exempt organizations. This argument seems weak to us. Charities' tax returns are already subject to disclosure without violation of the first amendment. A more difficult problem is that reporting such a percentage may not effectively distinguish abusive practices from legitimate special purposes (e.g., the cost to new organizations of developing donor lists).

Despite their considerable evolution, the Forms 990 are frequently criticized both by charities who have difficulty completing them and by the public that has difficulty reading them.[56]

Both the Tax Section of the American Bar Association and Independent Sector have proposed revision and improvement of the Forms 990 to make them easier to complete and easier to use.[57] The proposals call for the Internal Revenue Services, charitable organizations, and various users of Forms 990 information to form a working group (perhaps facilitated by an outside consulting firm) to review the purposes of the form and see how the form may be most effectively designed to meet those needs. Since, in many cases, the forms themselves can be simplified only if there are related policy changes, any such review committee should not refrain from addressing changes that represent tax policy improvements whose principal efforts will be substantial forms simplification.

2. Repeal Requirement for Newspaper Notice By Private Foundations

Under current law private foundations must publish a notice of availability of their annual return in a newspaper having general circulation in the county of their principal office. A proposal to repeal this requirement was included in the AICPA 1990 tax simplification proposals.[58] The value of this requirement was always questionable, but makes even less sense in this age of increasingly electronic media and the public availability of these forms through such organizations as the National Center on Charitable Statistics, which obtains them from the IRS. The current filing requirement, moreover, can be met through publication in almost any newspaper, no matter how obscure. Although a seemingly minor requirement, the newspaper notice requires that the foundation prepare a return and then delay actual filing of the return with the IRS until the notice has been placed in any newspaper, the newspaper publishes it, the foundation officer obtains a copy of the paper, and then a copy is attached to the form. This requirement probably involves the waste of a few million dollars to society and an equivalent loss of charitable activity. On the general principle discussed above that the benefits of disclosure should be related to their costs, this requirement has no current justification.

3. Require Public Availability of All Rulings and Advice Issued to Tax Exempt Organizations

When Congress enacted new rules for public disclosure of rulings, determination letters, information letters, and technical advice memoranda in 1976 (section 6110), it failed to extend these rules to disclosure of documents relating to tax exempt organizations, because it was

[56] As noted on the front of the forms, the IRS reports that the estimated average time needed to complete and file Forms 990 and 990-PF is 127 hrs. 53 min. and 199 hrs., 56 min., respectively. This estimated time required to complete and file Forms 1120 and 1065 are 192 hrs., 28 min. and 98 hrs., 35 min. (This comparison was suggested by Herbert J. Lerner of Ernst and Young.)

[57] American Bar Association, 1994; Independent Sector, 1993.

[58] American Institute of Certified Public Accountants, 1990, p.1-15.

believed that the law already allowed for such disclosure (under section 6104). While section 6104 does allow the disclosure of a broad range of documents related to the successful application for tax exemption, documents relating to unsuccessful applications and issues other than application for tax exemption are not to be disclosed by the IRS to the public. Ironically, this results in less public disclosure of information relating to charitable organizations than is generally the case for taxable organizations. In certain circumstances the IRS has been able to overcome this problem and has been able to publicize adverse actions by requiring a press release as a condition for a closing agreement. Otherwise it cannot unilaterally advise the public of the basis for its adverse action.

Paul Streckfus of Tax Analysts has proposed relaxation of the disclosure restriction under section 6104 for increased public access to information concerning tax exempt organizations. One advantage of broad availability of this information would be better understanding of the administration of the tax laws by the IRS. Public availability of adverse rulings could have a strong deterrent effect on abusive behavior. The Section of Taxation of the American Bar Association, recognizing that normal concerns about taxpayer privacy generally do not apply to charitable organizations, proposes relaxation of the restriction under section 6103 in order to allow the IRS to share information about taxpayers with other government agencies conducting investigations of tax exempt organizations. Information on unrelated business income activity might still be protected in a manner similar to that afforded to other for-profit organizations, depending on the need for such protection and whether some disclosure might reveal the extent to which the organization is devoted to non-exempt purposes.

4. Require All Information Returns Pertaining to Nonprofit Organizations to be Filed in One IRS Service Center

IRS service centers are currently unable to provide timely responses to requests for information returns. Nor are they able internally to follow up on incomplete returns and missing returns in a swift manner.[59] One way to mitigate this problem would be to set up a separate private repository of the computerized return information for public charities (like that currently available to the private foundation community at the Foundation Library Center). Alternatively, the IRS could establish a single central computerized exempt organization information center. Single-site filing would permit the verification, collation and posting of information on a uniform basis. Electronic paperless reporting will eventually replace the current service center function. Until that time, it would be advantageous to have one service center (such as the one in Ogden, Utah) assigned to the task of uniform processing of returns. Then the Statistics of Income Division of the IRS could establish statistical analyses and verification programs for preparation of reports, and the returns collected in the central service center could be made available to the public for a fee. Note that this simplified filing and retrieval system could have a significant deterrent effect on the efforts of some organizations

[59] One example of the serious data reporting and follow-up problems was reported by Nancy Haycock, 1992, p.4. This report noted that when 24,211 organizations listed in a New York survey were compared to 19,721 on the IRS file, the New York list contained more than 10,000 not on the IRS list, and the IRS had 9,000 not on the New York list. Many of the inconsistencies were due, not simply to nonfiling with IRS, but to fiscal sponsorship of one group by another and similar problems.

to avoid disclosing information required on forms, particularly on officers' salaries and directors' compensation. Indeed, public disclosure is severely hampered today by the inadequate disclosure of required information and the inability of IRS to follow up immediately to demand complete disclosure. We understand that the IRS is aware of these difficulties and may be moving in the direction indicated here.

PART VI. CONCLUSION: A PLAUSIBLE PACKAGE OF SIMPLIFICATIONS AND OTHER REFORMS

The objective of this concluding section of our paper is to summarize how the suggestions made in Parts I through V might be assembled into a legislative package that would strengthen the charitable sector and promote charitable giving, while at the same time making the tax law adhere more satisfactorily to general tax principles.

A. Hidden Tax Rates

- Eliminate the limitation on itemized deductions for upper-income households and the personal exemption phase out. Replace hidden tax rates with equivalent statutory tax rates on taxable income in order to allow full deductions for charitable contributions.

B. Percentage of Income Limitations

- Eliminate the 30 percent-of-income limit on gifts of capital gain property to charities.

- Eliminate the 20 percent-of-income limit on gifts of capital gain property to private foundations.

- Eliminate the 30 percent-of-income limit on gifts to private foundations.

- Consider eliminating the 50 percent-of-income limit on all charitable contributions, with a carryover for gifts that reduce taxable income below zero. If a limit on charitable giving must be maintained for "minimum tax" purposes, then keep one simple limit, such as the 50 percent-of-income limit on all gifts. However, apply only to charitable contributions of $50,000 or more, and grant special exceptions for awards, prizes, donations of speaker fees, and similar common practices.

C. Valuation of Appreciated Property Donated to Foundations

- Grant appreciated property donated to foundations the same treatment accorded to donations of this property to other charities.

D. Charitable Giving Until April 15

- Treat charitable contributions like deductions to individual retirement accounts and allow deductions for the previous calendar year up to April 15 or time of filing, whichever is first.

E. Excise Tax on Investment Income of Private Foundations

- Repeal two-tier excise tax and apply a single rate of excise tax to foundations. Eliminate the additional tax on those foundations whose grants do not rise above a base derived from grants made in previous years.

- Use a simple base, preferably foundation net worth, for applying the excise tax rate.

- Ideally, the excise tax should be eliminated. At a minimum, the rate should be reduced to better reflect the audit fee justification used by Congress.

- If an audit fee is maintained, some of it should be devoted to improved statistics and disclosure. An informed public is a most effective way to audit abuse and improve the operations of the charitable sector.

F. DISCLOSURE

- Streamline the annual information returns filed by charities.

- Repeal requirement for newspaper notice by private foundations.

- Require public availability of all rulings and advice issued to tax-exempt organizations.

- Require all information returns pertaining to nonprofit organizations to be filed in one IRS Service Center.

These proposals are not meant to be comprehensive. Nor are they without controversy. However, we believe that, taken as a whole, they demonstrate that the tax laws pertaining to charitable giving and the charitable sector can be simplified and redesigned in ways that promote giving in a more equitable and cost-effective manner.

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