

## Election Year Proposals Affecting Charities: A Prelude to Future Legislation?

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*The outcomes of these policy debates could have considerable impact on the nonprofit sector.*

In 2000, the candidates running for president and the Clinton administration developed a number of legislative proposals that would affect the nonprofit sector, both directly and indirectly. These proposals would influence charitable giving and the way in which some charitable organizations operate. It remains to be seen which proposals ultimately will be enacted. Nonetheless, they illustrate the kinds of policy changes that are likely to be considered in the near future.

The Urban Institute's Center on Nonprofits and Philanthropy and Harvard University's Hauser Center for Nonprofit Organizations convened the third Seminar on Emerging Issues in Philanthropy in May 2000. The day-long roundtable brought together researchers, government officials, and nonprofit executives and advisers to discuss three types of proposals: those affecting charitable giving, those affecting charitable organizations, and those affecting faith-based organizations. This brief summarizes their main features and possible effects on charities and charitable giving.

### Proposals Affecting Charitable Giving

Most policymakers agree that encouraging the public to give to charity is a worthy policy objective, and many acknowledge that tax breaks can provide effective incentives for charitable giving. These incentives can encourage a person to make gifts from his or her annual income, individual retirement account (IRA), or estate.

### Extend Charitable Tax Deductions

One way to encourage charitable giving is to make it less expensive. Currently, taxpayers who itemize their deductions can claim a tax deduction for charitable contributions. The effect is to lower the taxpayer's cost of giving by anywhere from 15 cents per donated dollar for some taxpayers to 40 cents per donated dollar for others.

Several limits exist on the charitable deduction. Taxpayers may deduct cash contributions of up to 50 percent of adjusted gross income (AGI) if the donation is to a public charity or up to 30 percent of AGI if the donation is to a private foundation. Gifts of capital gains property are deductible up to 30 percent of AGI when contributed to a public charity and up to 20 percent of AGI when donated to a private foundation. Corporations may deduct contributions of up to 10 percent of their taxable income.

The Clinton administration proposed increasing the AGI limit on cash donations to private foundations from 30 percent to 50 percent and the AGI limit on gifts of appreciated property to private foundations from 20 percent to 30 percent. As a result of this proposal, donations to either public charities or private foundations would share an AGI limit: 50 percent for cash donations and 30 percent for gifts of appreciated property. Candidate Bush proposed raising the cap on corporate charitable deductions from 10 percent to 15 percent and limiting the liability of corporations that donate goods to charitable organizations. The interest of both parties in raising some deduction limits indicates that this

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issue may receive attention in future legislative sessions.

A bipartisan movement is pushing to extend charitable deductions to nonitemizers, the majority of taxpayers.<sup>1</sup> Although the specifics of these proposals differ, they all address how a likely increase in charitable giving due to expanding the deduction to all taxpayers compares with the associated revenue cost. Included in the revenue cost are windfalls conferred on taxpayers who would receive tax reductions for their current level of contributions. Since the standard deduction allows for a certain level of charitable giving, some analysts object to the introduction of a new deduction because it grants a double deduction for charitable gifts.

One way to address these concerns and maximize the effectiveness of the tax incentive is to allow a deduction only for contributions made in excess of some minimum amount, referred to as a contribution floor. For example, the proposals introduced in the 106th Congress include floors that range from \$50 (\$100 for joint filers) to \$1,000 (\$2,000 for joint filers). All of the proposals to extend the charitable deduction to nonitemizers include such a floor.

Restricting deductions to donations made in excess of a floor increases the likelihood that taxpayers will be rewarded with a tax cut only if they increase their charitable giving. It also recognizes that the standard deduction accounts for a “typical” level of giving.

Tax complexity and revenue cost could also be reduced substantially if there were a common floor for itemizers and nonitemizers, but few proposals tackle this issue.<sup>2</sup>

### **Charitable IRA Rollovers**

Charitable IRA rollovers would simplify the process of making charitable donations from IRAs and possibly

avoid limits placed on other giving. The proposed Charities Empowerment Act of 1999 was one of several bills introduced in Congress that provides for such tax-free IRA rollovers. As a presidential candidate, Bush advocated permitting individuals over age 59 to contribute IRA funds to charities tax free.

### **The Estate Tax**

Under current law, the first \$700,000 of an estate is exempt from taxation.<sup>3</sup> Estates that exceed this are taxed at rates that start at 37 percent above the \$700,000 exemption and rise to 55 percent for estates that are larger than \$3 million.<sup>4</sup>

While, as presidential candidates, John McCain and Steve Forbes advocated immediately abolishing the tax, candidate Bush proposed gradually phasing out the estate tax over eight years. Under his proposal, all estate taxes would be eliminated by 2009.<sup>5</sup> According to the *New York Times*, under Bush’s scenario revenue loss through 2010 would amount to \$105 billion, and annual revenue loss after full repeal would be \$50 billion (*New York Times* 2000).

Presidential candidate Gore supported targeted changes to the estate tax, including increasing the exemption from \$2.6 million to \$5 million upon the death of a surviving spouse who owns a family business or farm. Gore also advocated expanding the current deduction for landowners who transfer properties near cities, parks, or wilderness areas to conservation.

Any change to the estate tax will affect the nonprofit sector. Since charitable bequests are fully tax deductible, the cost of making this type of bequest is significantly lower than the costs of making other types of bequests. Reducing or eliminating the estate tax would thus reduce or eliminate a financial incentive to make charitable bequests. Most researchers agree that the transfer tax encourages charitable giving both

during one’s lifetime and at death. If the estate tax is repealed, contributions by wealthy individuals may decrease by as much as 12 percent (Joulfaian 1998). However, this estimate is lower than many might have expected. While the incentive to give is reduced, the greater wealth left to individuals tends to provide some offsetting influence.

### **Proposals Affecting Charitable Organizations**

Various legislative proposals have been designed to increase donations to charities made through intermediary organizations. Private foundations are subject to taxes and minimum payout rates that some experts feel are too restrictive. Proposals limiting these taxes and changing the rates are currently being debated. Other organizations, such as those that handle donor-advised funds, are subject to fewer restrictions. Proposed regulation and legislation would tighten the rules for these organizations in order to clarify their charitable purpose.

### **Private Foundations**

Private foundations generally act as a conduit through which funds are distributed to charitable organizations and activities. Currently, the net investment income of private foundations is subject to a 2 percent excise tax.<sup>6</sup> This rate falls to 1 percent for private foundations whose distribution of funds exceeds its average payout rate for the previous five years. This rule discourages foundations from significantly increasing their distribution of funds in any individual year for fear that in subsequent years it will be harder to qualify for the lower tax rate.<sup>7</sup>

The Clinton administration proposed to simplify the tax by replacing the two-tiered system with a flat 1.25 percent tax rate. However,

because the introduction of the flat tax will represent an increase to those foundations currently at the 1 percent rate, some experts encouraged the administration to recommend decreasing the rate to 1 percent. Others advocated decreasing the rate even further, because the tax revenue is well in excess of the amount spent to monitor the charitable sector—the purported purpose of the tax.

A reduction of the excise tax should slightly increase the amount distributed to charity because private foundations can count the tax toward their payout obligation. However, even if there were no reduction, the flat rate would significantly simplify the filing requirements placed on foundations and remove the disincentive to increase giving.

Private foundations, in general, are also required to distribute at least 5 percent of the value of their investment assets to charity each year. In contrast, Congress imposes no current spending obligation on public charities.<sup>8</sup> Some advocates suggest increasing the private foundation “minimum distribution” requirement; others suggest eliminating it. Increasing the payout rate beyond a sustainable level raises issues about the desirability of permitting a foundation to indefinitely sustain the grantmaking capacity of its endowments; eliminating the obligation raises questions about the role of the federal tax system in regulating the timing of charitable expenditures by foundations.

### *Donor-Advised Funds*

Despite their resemblance to private foundations, donor-advised funds, which result from the pooling of gifts from numerous donors, are classified as public charities. As such, donor-advised funds are subject to less regulation and more generous percentage-of-income annual deduction limits than private foundations.

Community foundations have long operated donor-advised funds.

However, the recent explosive growth in donor-advised funds run by newly created charitable arms of financial institutions has brought them to the forefront of discussions on trends in charitable giving. These multibillion-dollar commercially managed funds attest to the appeal of “democratizing” endowments assets.<sup>9</sup> Donors claim an immediate deduction for the amount contributed to their fund but maintain control over the distribution of assets they contributed to the fund, which itself usually holds a diversified portfolio of assets. The lack of guidelines akin to the private foundation regime has resulted in a call to clarify the legal status of the funds and to try to ensure against abuse.

As a result, in 2000 the Clinton administration proposed that a charitable organization whose primary activity is operating donor-advised funds must meet the following three requirements to qualify as a public charity.

- Donors maintain advisory privileges but do not explicitly control their fund’s assets and income.
- Fund assets and income are distributed only to public charities, private operating foundations, and government entities.
- The charitable organization annually distributes at least 5 percent of the aggregate assets it holds in donor-advised funds. (Excess contributions in one year can be carried forward for up to five years; many donor-advised funds have already voluntarily agreed with this requirement.)

### *Section 527 Nonprofit Organizations*

Section 527 was created in 1974 to keep the tax treatment of political contributions separate from a candidate’s gross income. Political parties and committees, which are subject to Federal Election Commission (FEC) regulation, have traditionally made

up the bulk of Section 527 organizations, which are tax exempt. They can be used to fund activities such as polling, ballot initiatives, grassroots lobbying, voter guides, and issue ads. Contributions to Section 527 groups are not tax deductible.

In the 2000 election cycle, a new type of Section 527 organization not subject to FEC regulation has been used in record numbers by candidates in both parties to fund aspects of their campaigns. These new Section 527 organizations avoid activity-based FEC requirements by categorizing their activities as “issue advocacy,” which is not subject to disclosure rules, rather than as “express advocacy,” which is subject to disclosure rules. Both political parties have benefited from targeted use of Section 527 organizations’ spending. The Sierra Club’s Section 527 organization funded ads criticizing candidate Bush; Republicans for Clean Air, another Section 527 organization, funded commercials criticizing candidate McCain’s environmental record.

Until July 2000, these so-called “stealth funds” were unregulated. Versions of legislation drafted to request disclosure by Section 527 organizations included a Republican-backed bill that required disclosure for other nonprofits, including social welfare organizations, unions, and trade associations. Another alternative, drafted by the Democrats, included corporations.

A narrower bill, “The 527 Campaign Ad Disclosure Act,” reflected a compromise to focus exclusively on Section 527 organizations that do not report to the FEC. This recently enacted law requires Section 527 tax-exempt groups that do not report to the FEC and that raise at least \$25,000 a year to disclose to the Internal Revenue Service a number of details: their officers, address, size of donations, names of each donor giving more than \$200, and expenditures.

The IRS will publish these filings on its Web site.

## Proposals Affecting Faith-Based Organizations

A wide range of proposals affect “faith-based charities”—charitable organizations with ties to religious organizations—by increasing their ability to receive government funding that for the provision of certain social services. These bills have received bipartisan support in Congress and have been embraced by the Clinton administration and both presidential candidates.

### *Extend Charitable Choice*

Congress encouraged faith-based organizations to compete with secular organizations for job training and job placement contracts with passage of the “Charitable Choice” provision included in 1996 welfare reform legislation. In 2000, the Clinton administration and both presidential candidates supported broadening the types of social services for which faith-based organizations compete for funding.

The most sweeping proposed reform is in the Charitable Choice Act of 1999. This bill states that faith-based organizations accepting government funds will not be required to change their religious character, systems of internal governance, or requirements that employees follow religious teachings.<sup>10</sup>

President Clinton’s antipoverty package, the New Markets/Renewal Communities Agreement, also included limited charitable choice measures. The Clinton administration further proposed opening a percentage of program funding to competitive bidding for faith-based organizations. For example, the administration advocated opening 10 percent of the

21st Century Program, one of the largest federal sources of funding for school-based after-school activities, to competitive bidding.

Presidential candidate Bush supported applying Charitable Choice to all federal programs that award funds to nongovernmental organizations. He also advocated establishing an “Office of Faith-Based Action” in the executive office to assist faith-based organizations that seek government funds and making federal matching funds available to states to establish their own offices of faith-based action. Bush supported making performance-based grants for drug treatment programs available to states to ensure that nonmedical faith-based organizations are eligible to receive federal funds. In the campaign, Bush also sought to extend Charitable Choice beyond current legislative proposals by backing licensing regimes at the state and federal levels that recognize religious training as an alternative form of qualification.<sup>11</sup>

Presidential candidate Gore favored extending Charitable Choice to additional services, including drug treatment, homelessness, youth violence prevention, marriage preparation, mentoring, and counseling. He also encouraged corporations to match employee contributions to faith-based organizations.

### *State Charity Tax Credits*

The proposed Charity Empowerment Act of 1999 would permit states to create a nonrefundable tax credit of between 50 percent and 90 percent against state income tax (or, for states with no income tax, a comparable tax). For individuals who contribute to a qualified charity, the credit would be as much as \$50 (\$100 on a joint return) and may increase by \$50 per year to \$250. Organizations that assist the poor would qualify. To

fund this credit, states would be allowed to draw on their surplus federal money from the Temporary Assistance for Needy Families (TANF) program.

Presidential candidate Bush proposed a state tax credit of up to 50 percent of the first \$500 (\$1,000 on a joint return) for contributions by individuals to antipoverty charities. Combined with an itemized deduction for the same contribution, the federal government would subsidize between 80 percent and 90 percent of such gifts. In contrast to the proposed Charity Empowerment Act (which raises the difficult issue of defining antipoverty), Bush’s proposal would allow states to designate the charities they wish to target. Candidate Bush also supported expanding the credit to corporations, which would be eligible for a tax credit of 50 percent of the first \$1,000 donated to state-selected antipoverty charities.

Both proposals provide some incentive for individuals to increase donations to antipoverty charities or to move existing donations toward antipoverty efforts. However, to the extent that individuals already donate to such charities, large percentage subsidies for first-dollar gifts would reward contributors for doing what they would have already done.

Some opponents of the state tax credit proposals object to using funds earmarked for needy families to credit charitable giving. Others oppose any measure that will divide charities into “good” and “better” categories and argue that targeted tax credits affect donors’ rights to give to the charities of their choice. Moreover, since an organization’s beneficiaries may change from year to year, as may beneficiaries’ economic status, implementing a definition of an “antipoverty” organization may prove quite difficult. To qualify, organizations might reorganize,

cancel some existing (nonqualifying) services, or set up subsidiaries.

## Future Legislative Activity

Future legislative sessions are certain to debate the proposals raised in the election year. The outcomes of these policy debates could have considerable impact on the nonprofit sector.

Proposals to repeal the estate tax, expand the charitable tax deduction, introduce tax-free charitable IRA rollovers, and create state-level targeted charitable tax credits could significantly change the amount and type of giving the nonprofit sector receives each year. Widespread support for expanding charitable choice provisions could open up more government funding to programs based in faith-based organizations, expanding their opportunities and affecting how all nonprofits compete for federal money. Finally, proposed changes to the regulation of donor-advised funds, Section 527 organizations, and private foundations could simplify and add clarity to areas of nonprofit-sector regulation.

## Endnotes

1. About 70 percent of individual taxpayers are nonitemizers.
2. For further information, see Cordes, O'Hare, and Steuerle 2000 and Steuerle 2000c.
3. This amount is scheduled to increase to million by 2006.
4. Only the wealthiest 2 percent of Americans who die this year will leave behind taxable estates. Estate tax revenue is projected at \$26.7 billion in 2000.
5. The reduction is proposed in steps: 5 percent in 2002 and 2003, 10 percent in 2004, 15 percent in 2005, 20 percent in 2006, 30 percent in 2007, 40 percent in 2008, and fully in 2009.
6. The tax was originally instituted by the Tax Reform Act of 1969 to fund IRS regulation of the nonprofit sector, but it has always brought in far more revenue than was used

for regulation and was never earmarked for this program.

7. See Steuerle and Sullivan 1996.
8. Public charities are also known as Section 501(c)(3) organizations.
9. See Steuerle 1999.
10. This provision excludes certain children's education programs including Head Start and primary, secondary, and higher education.
11. As governor of Texas, Bush exempted from state licensing requirements those faith-based drug treatment programs that do not provide medical treatment. In Texas, Prison Fellowship Ministries runs a unit of the state prison and established the nation's first 24-hour-a-day faith-based prerelease program. Bush proposes funding similar programs at four federal prisons.

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