



INDEPENDENT SECTOR
A vital voice for us all

HOUSE WAYS AND MEANS COMMITTEE

TAX REFORM WORKING GROUP ON CHARITABLE AND EXEMPT ORGANIZATIONS

April 15, 2013

Importance of the Charitable Sector

Every day, charitable nonprofit organizations, among many other contributions, provide educational and economic opportunities for families in need; work to alleviate poverty and suffering at home and abroad; assist victims of disaster; enhance the cultural and spiritual development of individuals and communities; facilitate scientific advances; and foster worldwide appreciation for the democratic values of justice and individual liberty that are part of the American character.

Social Venture Partners of Seattle, for example, has provided \$10 million and 25,000 hours of volunteer consulting since 1997 to advance promising nonprofits like New Energy Cities. NEC works with community stakeholders in cities like Spokane and Edmonds to accelerate a transition to clean energy while creating jobs and building healthier communities.

The American Cancer Society, based in Georgia, works across the state and the nation to eliminate cancer as a major health problem by advancing preventative skills, saving lives, and diminishing suffering from cancer, through research, education, advocacy, and service. ACS advocates for policies that support this mission, which includes increased access to health care, smoke-free ordinances and support for cancer research.

The charitable sector is also a critical component of the nation's economy. Nearly one in 10 workers in the United States is employed by a nonprofit organization, and with 13.5 million paid workers, we employ more people than the finance and real estate sectors combined. Further, these organizations pay nearly \$670 billion annually in wages and benefits, salaries that support families in communities across America. In 2010, 501(c)(3) organizations paid \$35.2 billion in payroll taxes.¹ In addition, 64.3 million Americans contributed more than 7.9 billion hours of volunteer service in a formal

¹ National Center for Charitable Statistics (NCCS), The Urban Institute, The Nonprofit Almanac 2012.

organization in 2011, the equivalent of 4 million full-time jobs valued at approximately \$171 billion.²

The charitable sector's broad community impact and public support is evidenced by the breadth of its funding sources. Millions of Americans make donations each year, collectively providing nearly \$300 billion³ to support the work of charitable nonprofit organizations. But charitable donations are only part of what is needed to ensure that the sector's programs and services can continue. More than 52 percent of revenue across the sector is derived from fees paid for services, ranging from tuition and patient care charges to event admission fees. Nearly one-third of additional nonprofit sector revenue is generated through partnering with all levels of government to deliver programs and services like after-school care, nutrition assistance, and nursing home care for elderly and disabled Americans.⁴

Impact of the Economic Downturn

The struggling economy and sluggish recovery have made it more difficult for charitable organizations to serve their missions, as America's nonprofits have been hit hard financially in recent years. The Nonprofit Finance Fund, a 501(c)(3) nonprofit community development financial agency, surveyed over 4,500 nonprofit organizations in January 2012, and found merely one quarter of them operating above a break-even point.⁵ Fifty-seven percent of organizations only had enough cash on hand to cover three months or less of expenses, and 87 percent of respondents indicated their financial outlook would not improve in 2012.

Like their counterparts in other major sectors of the economy, many charitable nonprofit employers have struggled to meet payroll during recent years, and countless more have been unable to hire additional workers needed to keep pace with an increased demand for services. In 2011 alone, 23 percent of charitable nonprofit organizations reported cutting staff, 21 percent froze or reduced salaries, and 11 percent reduced employee benefits.⁶

These financially challenging times also have seen a significant increase in demand for help from those most in need, as documented in numerous studies. According to the Nonprofit Finance Fund survey, 85 percent of charitable nonprofits experienced an increase in the demand for services in 2011, and 88 percent of respondents expected

² Corporation for National and Community Service, "Volunteering in America," 2012

³ Giving USA Foundation (2012). Giving USA 2011: The Annual Report on Philanthropy for the Year 2011.

⁴ National Center for Charitable Statistics (NCCS), The Urban Institute, The Nonprofit Almanac 2012. Sources of Revenue for Reporting Public Charities: NCCS calculations of IRS Statistics of Income Division Exempt Organizations Sample (2007); NCCS Core Files (2009); American Hospital Association (AHA) 2009 survey; and the National Health Accounts, produced by CMS.

⁵ Nonprofit Finance Fund, "2012 State of the Sector Survey," 2012

⁶ Ibid

that demand to increase again in 2012.⁷ Additionally, an annual survey conducted by Catholic Charities found that its agencies had served more than 10 million people in 2011, an increase of over 25 percent over 2007.⁸

Many charitable nonprofit organizations have struggled to keep pace with this increased demand in part because they saw revenues fall during the economic downturn. Since 2007, annual charitable giving has declined by almost \$13 billion⁹ as Americans continue to struggle to navigate a difficult economy. Additionally, federal, state, and local budget cuts from the sequester and otherwise, coupled with delayed reimbursements from government for contracted services¹⁰ and a decline in foundation support every year since 2008,¹¹ have further burdened and diminished the capacity of public charities.

Tradition of Giving in Tax Policy

While almost all Americans are generous contributors to causes they care about, the vast majority of donations come from taxpayers who take the charitable deduction. More than 80 percent of the 46 million Americans who itemized their tax returns in 2009 claimed the charitable deduction. These individuals and families, who represent barely one quarter of all taxpayers, are responsible for more than 76 percent of individual contributions to charitable organizations.¹²

Congress has long recognized the connection between the tax code and its effect on donations to charitable organizations, dating to the inception of the charitable deduction in 1917. The generosity of Americans, further encouraged through tax incentives, has made possible extraordinary contributions of charitable organizations in local communities, large cities, rural areas and those focused abroad all dedicated to improving life for all.

Recognizing the power of the tax incentive to stimulate additional giving, in the days following the devastating January 2010 earthquake in Haiti, legislation was enacted allowing taxpayers to claim a 2009 deduction for donations made to Haiti relief efforts between the date of the earthquake and March 1, 2010. Similar extensions were

⁷ Ibid

⁸ Catholic Charities USA, 2011 Annual Survey Final Report, Center for Applied Research in the Apostolate, Georgetown University, Washington, DC, August 2012.
https://www8.georgetown.edu/centers/cara/ccusa11_report/CCUSA_2011_Annual_Survey_Report.pdf

⁹ Giving USA Foundation (2012). Giving USA 2011: The Annual Report on Philanthropy for the Year 2011.

¹⁰ A 2010 survey by Urban Institute on states and government contracting showed that Michigan and Ohio ranked near the bottom in late reimbursement payments to nonprofits.

<http://www.urban.org/uploadedpdf/412227-National-Study-of-Nonprofit-Government.pdf>

¹¹ Giving USA Foundation (2012). Giving USA 2011: The Annual Report on Philanthropy for the Year 2011.

¹² Source: IRS Statistics of Income data for 2008. Does not include bequests and estates.

enacted following the Southeast Asia tsunami of 2004, Hurricane Katrina in 2005, and storms in the American Midwest in 2008.

Moreover, the power of the incentive can be seen in the timing of charitable gifts. Between 2003 and 2009, charitable organizations in the U.S. received \$281 million in online donations. More than 22 percent of those donations are made on December 30 and 31 each year, underscoring the extent to which donors are aware of, and influenced by, the tax implications of their giving.¹³

Fairness of the Charitable Deduction

While some advocates of changing the charitable deduction believe it disproportionately benefits high-income taxpayers, this is *not* the case. The current tax code treats every taxpayer who claims the deduction equitably; regardless of the rate at which their income is taxed, people are not required to pay taxes on the portion of their earnings donated to charity.

Some have said that the charitable deduction disproportionately benefits those charities favored by wealthier donors. Specifically, it is suggested by some that donors claiming the charitable tax deduction primarily support the arts, universities, and other organizations perceived to be well-financed at the expense of charities that provide direct service to needy individuals and families. In fact, reducing the value of the charitable deduction for higher-income taxpayers will diminish the impact of services across the sector. A 2012 study by the Center on Philanthropy at Indiana University found that 79.3 percent of high-net-worth households,¹⁴ those defined as having annual income greater than \$200,000, donated to basic needs charities in 2011, with their average gift to basic needs organizations increasing by 17.5 percent since 2009.¹⁵ The reality is that Americans in every income bracket give generously to all types of charitable organizations, and reducing incentives to give will hurt all charities and the causes they serve.

It is also important to keep in mind the unique nature of the charitable deduction. Unlike incentives to save for retirement or purchase a home, for example, the charitable deduction encourages behavior for which a taxpayer receives no direct tangible benefit. The charitable deduction does not subsidize personal consumption or underwrite the accumulation of personal wealth. It simply and effectively encourages taxpayers to give away a portion of their income to benefit others.

¹³ "Online Giving Study: Donations Driven by Donor Experience, Year-End Gifts and Large-Scale Disasters." Network for Good and True Sense Marketing, Dec. 2010, reported in *Philanthropy News Digest*, Dec. 15, 2010.

¹⁴ Households with annual income greater than \$200,000 and/or personal wealth of at least \$1,000,000.

¹⁵ "The 2012 Study of High Net Worth Philanthropy," Center on Philanthropy at Indiana University, November 2012

Cost-effectiveness of the Charitable Deduction

This charitable tax incentive is also an extremely efficient way for the federal government to spur investment in communities. When an individual in the highest tax bracket donates \$1,000 to charity, the government foregoes just under \$400 in tax revenue. However, communities benefit from the entire \$1,000 gift. The government is unlikely to find another vehicle that can leverage private spending for community services at better than a 2.5-to-1 ratio. The charitable deduction directly and efficiently enables economic growth in our local communities and across the nation.

Impact of Proposed Changes to the Charitable Deduction

Despite the universal popularity of this tax incentive, during the past couple of years the voices considering limits on the charitable deduction have included administration officials, other public officials from both parties, and various fiscal commissions tasked with charting a course to long-term economic stability.

These proposals have included imposing a hard-dollar cap on all itemized deductions, implementing a percentage-based reduction, and introducing a partial tax credit available to taxpayers whose charitable giving exceeds some arbitrary threshold.¹⁶ Their impact would range from decreasing the value of the charitable deduction to effectively eliminating it entirely for many taxpayers.

The most active proposal to reduce the value of the charitable deduction has been the Obama Administration's effort to limit itemized deductions for taxpayers earning more than \$200,000 per year at 28 percent. When top marginal rates were 35 percent, experts predicted this proposal would cause charitable giving to decline by anywhere between \$1.7 billion¹⁷ and \$7 billion¹⁸ per year. With top marginal tax rates now at 39.6 percent, capping the charitable deduction at 28 percent would likely cause an even more drastic decline in giving.

Another proposal that has received some attention is an aggregate hard-dollar cap on itemized deductions. In response to Governor Romney's suggestion during the 2012 presidential campaign that a hard cap could be set at \$17,000,¹⁹ the National Association of Home Builders analyzed tax data from 2009 and found that of the \$20,464 in itemized deductions claimed by the average married, joint-filing taxpayer,

¹⁶ Both the National Commission on Fiscal Responsibility and Reform, also known as the Simpson-Bowles Commission, as well as the Debt Reduction Task Force, chaired by former Senator Pete Domenici and former OMB Director Alice Rivlin, called for replacing the charitable deduction with a credit.

¹⁷ "Impact of The Obama Administration's Proposed Tax Policy Changes on Itemized Charitable Giving." The Center on Philanthropy at Indiana University, October 2011.

¹⁸ "An Anti-Charity Tax, at the Worst Time." Martin Feldstein, *Washington Post*, March 25, 2009

¹⁹ Mr. Romney subsequently suggested \$25,000 might be an appropriate level at which to set an aggregate cap on itemized deductions.

\$17,329 of these deductions were consumed by home mortgage interest (\$10,365), state and local income taxes (\$3,667), and real estate taxes (\$3,287).

This effectively would have eliminated the charitable deduction for millions of taxpayers, and regardless of where an aggregate cap is set, even at \$50,000 as has since been suggested,²⁰ the result would force taxpayers to choose between the charitable deduction and those itemized deductions from which they directly benefit. For those taxpayers whose mortgage interest, local tax, and other similar deductions meet or exceed the cap, the charitable deduction will simply not be available to them altogether. And according to a 2012 Indiana University survey, more than two-thirds of high-net-worth donors said they would decrease their giving if they did not receive a deduction for donations.²¹ In fact, it has been estimated that with no charitable deduction at all, giving would decline by 36 percent.²² This would have resulted in a \$78 billion decline in individual charitable giving in 2011. We therefore urge you to reject policies that would place any limitations on the charitable deduction that would undermine its critical incentive effect.

Charitable Tax Extenders

In addition to preserving the individual tax incentive to encourage charitable donations, Congress might help charitable organizations secure the support they need to deliver much-needed programs and services by extending permanently the charitable giving incentives included in the annual tax extenders package. It is difficult to overstate the benefit for our community, and the people we serve, of extending permanently the IRA charitable rollover and the enhanced incentives for the donations of food inventory and land conservation easements.

IRA charitable rollover

The individual retirement account (IRA) charitable rollover tax incentive, first enacted in the Pension Protection Act of 2006, encourages older adults to make gifts to charities by enabling individuals age 70½ to donate up to \$100,000 to a qualifying public charity directly from his or her IRA without incurring tax on the withdrawal.

While previous lapses of this provision have made data difficult to compile, according to the nonprofit Partnership for Philanthropic Planning,²³ during the first two years the IRA charitable rollover option was available, it prompted more

²⁰ Sen. Rob Corker (R-TN) proposed a deficit reduction package in November 2012 that would have imposed a \$50k cap on all deductions.

²¹ The 2012 Study of High Net Worth Philanthropy, Center on Philanthropy at Indiana University, November 2012

²² "Charitable Giving, Income, and Taxes: An Analysis of Panel Data" Gerald E. Auten, Holger Sieg and Charles T. Clotfelter. *The American Economic Review*. March 2002.

²³ Formerly the National Committee on Planned Giving

than \$140 million in charitable donations, with the median gift just under \$4,500.²⁴ Beneficiaries have included social service providers, religious organizations, cultural institutions and schools – organizations that benefit communities and improve lives every day.

Enhanced deduction for contributions of food inventory

Since Section 170 of the Internal Revenue Code was enacted by Congress in 1976, our nation's tax system has encouraged donations of food inventory by allowing C Corporations to earn a tax deduction for donating surplus wholesome food that has been safely handled and donated to an approved public charity.

Under this provision, the allowable deduction is the donor's basis in the donated food plus one-half of the ordinary income that would have been realized had the food been sold at fair market value (capped at twice the donor's basis in the donated inventory). Congress made this enhanced tax incentive available to all business entities as part of the Katrina Emergency Tax Relief Act in 2005.

The expanded incentive has been vital, as community food pantries and other meal providers attempt to keep pace with the growing number of Americans who go to bed hungry every night.

Special rules for the contributions of capital gain real property for conservation purposes

First enacted as part of the Pension Protection Act of 2006, the enhanced deduction for donation of a conservation easement increases the maximum deduction a donor can take for donating a conservation easement from 30 percent of adjusted gross income (AGI) in any year to 50 percent of AGI. It also allows qualified farmers and ranchers to deduct up to 100 percent of AGI, and permits taxpayers to carry forward excess contributions for up to 15 years.

Conservation easements create a legally enforceable land preservation agreement between a landowner and a government agency or a qualified land protection organization (land trust) for the purposes of conservation. Such easements are cost-effective and voluntary, and the enhanced charitable incentive makes it possible for modest-income farmers, ranchers and other property owners to make such gifts.

²⁴ National Committee on Planned Giving. "Survey of IRA Distributions to Charity." March 24, 2008.

Within its first two years, the enhanced incentive helped America's land trusts increase the amount of land conservation by at least 535,000 acres.²⁵ The nonprofit Land Trust Alliance also estimates that the provision has helped America's land trusts work with farmers, ranchers and other modest-income landowners to increase the pace of conservation by one-third, to over a million acres per year.

Permanent enactment of these incentives will end the ambiguity and uncertainty caused by repeated lapses and subsequent re-enactments that have made it extremely difficult for donors and financial advisors to develop charitable giving plans, impeding the transfer of gifts that support much-needed services. The charitable giving incentives in the tax extenders package have encouraged individuals, large corporations, and small businesses actively to support the development and sustainability of their communities. They have spurred contributions, for example, to build cancer centers, develop counseling programs for at-risk youth, provide housing for homeless families, conserve wilderness areas, and offer art therapy for people with developmental disabilities. We urge the Committee to move forward with legislation to make these critical giving incentives permanent.

Good Governance: Background and Best Practices

Public charities understand that continued support from Americans who give of their time and money depends upon the high level of public trust in our sector, and that erosion of that trust will ultimately harm those we serve. We are therefore deeply committed to ensuring that public charities and private foundations are governed effectively and transparently, maintain maximum accountability, demonstrate the highest levels of ethical conduct, and fully comply with the law.

In October 2004, Independent Sector convened the Panel on the Nonprofit Sector with the written encouragement of Congressional leaders of both parties. The Panel undertook a comprehensive review of governance and other aspects of charitable sector practice in order to develop recommendations for action by Congress, the IRS, and the sector itself that would help charitable organizations maintain the highest possible standards of ethical conduct. The 24-member Panel conducted extensive outreach to solicit input and comments from the broader charitable community.

Many of the Panel's legislative and regulatory recommendations were incorporated into the Pension Protection Act of 2006, widely considered to be the most comprehensive reform of the charitable sector since the 1969 Tax Reform Act. Additionally, Panel recommendations were an important part of the charitable nonprofit community's input into the major redesign of the Form 990 subsequently

²⁵ Land Trust Alliance. "The Enhanced Easement Incentive." <http://www.landtrustalliance.org/policy/tax-matters/campaigns/how-the-easement-incentive-works>

undertaken by the IRS. The charitable sector's deep commitment to accountability, transparency and good governance stems from an understanding that doing so enhances our effectiveness and ultimately improves our ability to better serve individuals, families and communities.

Non-cash contributions

Non-cash contributions, including gifts of art, land, stock, securities, household goods, motor vehicles, clothing, among other items, are a significant source of support for many charitable organizations. Tax laws provide incentives for such contributions by permitting taxpayers to take an income tax deduction generally equivalent to the fair market value of property and other non-cash items donated to a qualified charity.¹ Specific rules apply to gifts of property that has appreciated in value since it was acquired by the taxpayer, while other conditions apply to gifts of conservation easements and gifts that have generally depreciated in value, such as motor vehicles, clothing, or household items.² Non-cash contributions accounted for roughly \$44 billion by taxpayers who itemized deductions on their federal income tax returns in 2010.

Taxpayers who claim a deduction for a single item or collection of items valued at \$5,000 or more are required to have a qualified appraisal to justify their claim, but the standards and definitions for qualified appraisals are vague. As a result, the Internal Revenue Service (IRS) has reported that some taxpayers have been over-estimating the value of donated property when calculating their income tax deductions.

Tax rules should be simplified to provide clear standards for establishing appropriate valuation of these gifts and facilitate taxpayer compliance, while retaining incentives for taxpayers to donate substantial gifts of furniture and clothing. To assist taxpayers in establishing the fair market value of donated goods, the responsibility should fall to the IRS to provide a clear standard for determining such values based on the "value guides" currently offered by many charitable organizations. Charitable organizations that are the recipients of these donations are also encouraged to make such lists available on their websites.

If Congress considers additional reforms, we encourage you to do so in a manner that balances a need for greater enforcement with providing opportunities to give back to their communities with non-monetary gifts. In the pursuit of compliance, we want to ensure that many smaller organizations whose operations are dependent upon large numbers of volunteers are not overburdened with additional requirements. Similarly, we would be cautious of any changes that place greater limitations on various vehicles outside of cash donations for Americans to demonstrate their generosity.

Complex Nonprofit Structures

The tax code allows organizations to be organized and operated in a variety of legal structures in order to provide flexibility for the goals and needs of the group. From a governance standpoint, tax-exempt parent entities have and should exercise oversight responsibility over their subsidiaries, in much the same way that for-profit parents have oversight over their subsidiaries.

There is nothing inherently wrong with a tax-exempt entity having one or more nonprofit or for-profit subsidiaries, as long as each entity is properly structured under the tax and corporate laws. In fact, among the reasons that public charities establish separate entities are to ensure compliance with tax law restrictions and to achieve liability protection. If Congress, whistleblowers, or others with knowledge of the operation have information of inappropriate activity, certainly that information should be provided to the IRS for investigation.

Unrelated Business Income Tax (UBIT)

As a result of persistent economic concerns, public charities have turned to a variety of revenue generation activities in order to adequately fund their operations. In some instances, charitable nonprofit organizations capitalize on opportunities that naturally arise from their day-to-day exempt operations, and in others, strategies are implemented to devote time and resources toward new income-producing activities. In either instance, the organization's income generating activities may or may not be substantially related to the organization's tax exempt purpose.

Any examination of current unrelated business income tax (UBIT) rules should be careful and recognize the diversity of the sector and its activities. At this time, much of the UBIT data is published and analyzed at the "tax-exempt organization" level, rather than broken down by 501(c) subsection. There is therefore a danger that legislative proposals and policy decisions will paint all tax-exempt organizations with the same brush, and impose unwarranted requirements or increased taxes on the sector. Even modest changes to the rules could substantially increase the tax liability of particular public charities, reduce the funds available for programs and services, and create further hardship for the people they serve. We urge Congress to engage in a dialogue with public charities and conduct thoughtful analysis to ensure that analysis of the current rules structure takes into account the breadth of activities undertaken by the broader charitable community.

Conclusion

Independent Sector recognizes and supports our collective imperative to put America on a sustainable fiscal path and spur economic growth. Indeed, the charitable

nonprofit sector, with our sizable workforce and significant investment in communities across America, can be a powerful partner in Congress's efforts to fuel recovery. As you consider proposals to improve our economy, simplify the tax code, and reduce the debt we urge you to consider both the short-term and the long-term consequences of all proposals before you. One such idea we believe should have no place in these deliberations is reducing or eliminating the charitable deduction. Over the years this provision has encouraged millions of Americans to step up and do precisely what we need them to continue doing now – give generously to improve their communities and build a better society.

The great strength of America's charities is that they allow individuals and groups voluntarily to commit their time, money, and creativity to advancing their own vision of the greater good. As a society, we have a profound interest in sustaining this rich diversity of the charitable sector. America's charitable sector is strong and vibrant in large part because the legal framework has encouraged a broad range of private initiatives for the public good, allowing individuals to form and support tax-favored charities for a wide variety of purposes. We strongly believe that this broad concept of charity should be preserved and encouraged going forward.

We also recognize the desire to identify bad actors and support regulations in place to ensure that charitable organizations are operating in a manner that reflects good governance, effective stewardship of charitable resources and ethical conduct. Self-regulation by the sector is an important complement to government oversight and regulation. Independent Sector's Principles for Good Governance and Ethical Practice and other resources are used by public charities and private foundations to enhance the accountability and transparency of their operations and ensure that they operate ethically. The charitable sector also supports an array of watchdog groups, management support groups, and infrastructure organizations that collectively serve to ensure accountability, build capacity, and promote excellence within nonprofit organizations. These resources and organizations play a critical role in helping charities go beyond the requirements of the law to achieve high standards of conduct and quality. Therefore, we urge the Committee to be deliberate and judicious in its examination of the tax code so that any proposed changes would not have unintended consequences of making compliance with the law unnecessarily burdensome for charitable organizations

As the Committee looks ahead and prepares for tax reform, it may also be instructive to look back to the Tariff Act of 1894, which first exempted from federal income tax organizations operated for charitable purposes, and the Revenue Act of 1917, which first made donations to charitable organizations tax deductible. In both instances, Congress embraced the entire range of social purposes and important causes that citizens – individually or collectively – might choose to pursue through charitable organizations. Whether focused on the arts, social services, scientific research, or spiritual matters, this great American tradition has sparked innovation, saved lives, and

enriched our communities. Through the wisdom of these decisions, Congress established century-old policies that have stimulated charitable giving and made it clear that our government and our society value the contributions made by every charitable organization.

Thank you for the opportunity to share these views with the Committee.

American Heart Association
Association for Healthcare Philanthropy
Easter Seals
Feeding America
Independent Sector
United Way Worldwide
YMCA of the USA