



## **CRS Report for Congress**

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

Jane G. Gravelle  
Senior Specialist in Economic Policy  
Government and Finance Division

### **Summary**

This report briefly discusses the development of proposals for tax incentives for charity embodied in H.R. 7 and S. 476 in the 108<sup>th</sup> Congress and S. 6 in the 109<sup>th</sup>; the revisions in the Pension Protection Act (P.L. 109-280), and prospects for future legislation. Proposed changes initially included charitable deductions for non-itemizers, rollovers of IRAs into charitable uses, a reduction in the excise tax on private foundation income, an increase in the deductions cap for corporate contributions, and several narrower provisions relating to business contributions of property and charitable remainder trusts. P.L. 109-280 included some of these changes, along with some revenue offsets.

Legislation involving tax incentives for charity began in the 107<sup>th</sup> Congress with the Community Solutions Act of 2001 (H.R. 7). This bill, adopted in 2001 by the House, had eight new tax provisions designed to benefit charitable giving including a capped deduction for non-itemizers. The President had proposed three of these tax provisions in his original 2001 tax proposal, but these provisions were not included in the 2001 tax cut (P.L. 107-16). Senate consideration also began in the 107<sup>th</sup> Congress with S. 1924, introduced by Senators Lieberman and Santorum, which would have provided a temporary non-itemizers deduction with a higher cap along with other provisions. The Senate Finance Committee reported this bill, the CARE Act of 2002, with a temporary non-itemizers deduction with both a floor and ceiling, but it was not considered on the floor, containing some other provisions of H.R. 7. A similar bill, S. 476 estimated to cost \$11 billion over 10 years, was passed by the Senate on April 9, 2003. A new version of H.R. 7 passed the House in 2003. This report summarizes the tax provisions affecting charitable contributions and briefly reviews the issues in most cases. The discussion begins with H.R. 7 and continues with the provisions in the Senate alternative. A 109<sup>th</sup> Congress bill, S. 7, included charitable provisions as well, and the Senate continued to propose some of these charitable provisions along with revenue raisers, which were enacted in 2006 in P.L. 109-280. The President's advisory panel on tax reform also proposed extending the deduction to non-itemizers and introducing a floor.

## Deduction for Non-Itemizers

Under current law a taxpayer can either itemize deductions (the major deductions are charitable contributions, excess medical expenses, mortgage interest, and state and local income and property taxes) or choose the standard deduction. The standard deduction is advantageous if that amount is larger than total itemized deductions. H.R. 7 would have allowed someone who takes the standard deduction to deduct charitable contributions. Singles could deduct amounts in excess of \$250 but not over \$500; joint returns may deduct the excess of \$500 not to exceed \$1000.<sup>1</sup> This provision was to be effective for the years 2004-2006. While in effect, this deduction is the largest provision accounting for \$1.4 billion of the \$2.2 billion cost in the first full year (FY2005). Over all 10 years (2004-2013) it accounted for \$2.9 billion out of \$12.7 billion (22%). This provision has not been adopted.

While the deduction for non-itemizers may increase giving, its effects would be limited because of the cap although increased in effectiveness per dollar of revenue by the floor. Even without a cap, the deduction is unlikely to induce additional giving as large as the revenue loss because evidence suggests that the responsiveness of taxpayers, particularly lower and moderate income taxpayers, to incentives is small.<sup>2</sup> The provision would also increase complexity of tax filing by including another line item. (A limited deduction for non-itemizers was formerly available for 1981-1986, enacted as part of the Economic Recovery Tax Act of 1981 (P.L. 97-34).)

## IRA Rollover Provision

The largest permanent tax provision in H.R. 7 allowed tax free distributions from individual retirement accounts to charities by individuals aged 70 and 1/2 and over, which originally cost \$204 million in the first year (9% of the cost), \$470 in the last year (33% of the cost, in FY2013), and 22% of the ten year cost. While this treatment may appear no different from simply including the amounts in adjusted gross income and then deducting them as itemized deductions, it can provide several types of benefits even to those who itemize. (In the absence of a general deduction for non-itemizers, it also permits such a deduction for eligible non-itemizers, or permits the avoidance of caps or floors). Apparently an important motivation was to reduce adjusted gross income which can trigger a variety of phase-outs and phase-ins, including the phase-in of taxation of Social Security benefits. There are also income limits on charitable contributions. Since IRAs tend to be held by higher income individuals, the taxpayers might be somewhat more sensitive to the incentive to give; however, it is not clear why this particular group of taxpayers is targeted. This provision was adopted in P.L. 109-280 with a \$100,000 annual limit.

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<sup>1</sup> This provision differs from the 107<sup>th</sup> Congress version which allowed a permanent provision with a cap beginning \$25 for singles (\$50 for joint returns) for 2002-2003, with the cap rising over time (\$50/\$100 for 2004-2006, \$75/\$50 for 2007-2009, and \$100/\$200 thereafter. The President's original proposal and his FY2003 proposal have no cap.

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

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

Under current law, there is a 1% tax on investment income of foundations, and an additional 1% if the foundation does not make a certain minimum distribution (based on distributions made in the previous five years), or has been subject to a tax for failure to distribute in the previous five years. H.R. 7 would have eliminated the extra 1% tax. This provision accounted for \$196 million (9%) in the first year, \$270 million (19%) in the last year, and \$2,273 (18%) for the 10-year period.

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

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

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

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

H.R. 7 added a new provision that limits the counting of administrative costs as part of a foundation's minimum distribution requirement. Foundations are required to make a minimum distribution of 5%, but that 5% can currently include administrative costs (which currently have only to be "reasonable"). As originally introduced earlier in 2003, the provision would have disallowed any administrative costs, but the proposal as reported allows deductions for most administrative costs, with some exceptions. This proposal was not adopted. (See CRS Report RS21603, Minimum Distribution Requirement for Private Foundations: Proposal to Disallow Administrative Costs, for an analysis.) This provision has not been adopted.

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

Under current law corporations can deduct charitable contributions of up to 10% of income; H.R. 7 would have gradually raised the cap to 20% (by one percentage point each year beginning in 2004, reaching 15% in 2008-11, and 20% thereafter).<sup>3</sup> This provision accounted for 4% of the first year cost, 19% of the final cost and 12% of the 10-year cost. Most corporate giving already falls well under the cap; the average giving is less than 2% of income.

There has been dispute over corporate charity, since shareholders could make their own decisions about charitable giving. In some views, charitable giving by corporations is another management perk that might be excessive because of monitoring problems by shareholders (this problem is also called an agency cost problem). Others argue that corporations should be encouraged to give to charity and to be socially responsible. Economists have studied models in which charitable giving is part of the firm's profit maximizing behavior (e.g., by gaining the firm good will). Evidence on the effectiveness of the deduction is mixed, with time series studies showing a positive effect and cross section results not finding an effect.<sup>4</sup> This provision has not been adopted.

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

Corporations that donate inventory to charity in general get a deduction for the cost (not the market value). A special rule allows businesses paying the corporate tax to also exclude half the appreciation (half the difference between market value and cost of production, if the inventory is given to an organization that directly passes it on to the ill, the needy, or infants, as long as the total deduction is no more than twice the cost. An important category of donations is that of food and there have been disputes between taxpayers and the IRS about how to measure the fair market value of food. H.R. 7 would have allowed unincorporated businesses (or businesses that are incorporated but do not pay the corporate tax) the additional deduction, and the fair market value of wholesome food would be considered the price at which the firm is currently selling the item (or sold it in the past), although this deduction would be limited to the corporate percentage cap on deduction in general. This provision accounted for 3% of the first year cost, and 6% of the last year cost.

The objective was to create more equity among types of taxpayers and resolve disputes (largely in the taxpayer's favor). However, one important concern about donated inventory is whether firms might be profiting from charitable contributions for items that they could not otherwise sell. P.L. 109-280 extended the provision to unincorporated

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<sup>3</sup> This provision is more generous than the 107<sup>th</sup> Congress version which would have raised the cap to 15%.

<sup>4</sup> See James R. Boatsman and Sanjay Gupta, "Taxes and Corporate Charity: Empirical Evidence from Micro-Level Panel Data," *National Tax Journal*, Vol. 49, June 1996, pp. 193-213.

business (not to exceed 10% of business income), making permanent a change adopted in the Katrina Emergency relief Act of 2005, but no other change was made.

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

Under current law, a shareholder in a Subchapter S corporation (a corporation treated as a partnership) was allowed to deduct his or her pro rata share of any corporate contribution. At the same time, the taxpayer must decrease the basis of stock by that amount (which is a way of reflecting the effect on the shareholder's asset position). The bill provides that the taxpayer will not have to reduce basis in the stock to the extent a deduction is taken in excess of adjusted basis of the donated property (e.g., cost). This provision appears to be consistent with allowing a deduction for the market value of appreciated property without including the appreciation in income (a special benefit generally available to taxpayers). This provision would have cost 1% of loss in the first year, and about 5% in the last year. It has not been adopted.

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

Current law provides tax deductions for some portion of a trust and income tax exemption on the earnings, if a remainder of the assets is left to charity (while paying income to a non-charitable donee, usually a spouse or other relative during an interim period). The trust's income is, however, no longer exempt from tax if the trust has unrelated business income. This provision liberalizes the rule by providing for a 100% excise tax on any unrelated business income rather than loss of all tax exemption. This provision accounts for a negligible share of the cost. This provision has not been adopted.

## **Contributions of Scientific and Computer Property**

Certain special treatment (similar to that for food inventory) is allowed for certain scientific property used for research and for contributions of computer technology and equipment, provided the property is constructed by the taxpayer. In concrete terms, this rule requires that no more than 50% of the cost is due to parts purchased elsewhere. This provision expired in 2003. The bill would allow property assembled, as well as constructed, to be eligible and make the provision permanent. This provision would account for 6% of the first year cost and 14% of the last year cost. It has not been adopted.

There are a number of other provisions in the 108<sup>th</sup> Congress version of H.R. 7 which are minor or were not addressed in the 107<sup>th</sup> Congress version. The most important one would exclude certain items (such as rent) received by a subsidiary from a tax on unrelated business income except for the excess over an arms-length price. This provision was adopted in P.L. 109-280.

## Modifications in the Senate Proposal; Final Changes

In the 107<sup>th</sup> Congress, the Lieberman-Santorum plan, S. 1924, would have provided non-itemizers deductions with a cap of \$400 (\$800 for joint returns); the Senate Finance Committee reported a version of S. 1924 (as a substitute for H.R. 7) with a temporary non-itemizers deduction with floor and a ceiling (\$250/\$500 for singles and \$500/\$1000 for joint returns) as in H.R. 7. A similar bill was introduced as S. 476 in the 108<sup>th</sup> Congress, with charitable provisions costing \$11 billion from 2003-2013, with \$2.8 trillion due to a two year non-itemizers deduction. This bill was passed by the Senate on April 9, 2003. The proposal included the IRA rollover provision but not the foundation excise tax reduction or the increase in corporate contributions cap. The remaining provisions of H.R. 7 discussed above were included although the provision for research and computer contributions was a temporary extension through 2005. There were also a number of additional provisions, although some of them relatively small. Another important set of provisions related to benefits for contributions for conservation purposes including a 25% exclusion from capital gains on the sale or exchange of property to the government for conservation purposes (\$766 million) and lifting contribution caps for contributions for conservation purposes (\$332 million). A third provision allowed the food inventory treatment for book inventories as well (\$283 million). There are a number of minor provisions as well. The bill also included increases in grants, as well as revenue offsets relating to tax shelters and user fees.

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

A similar bill, S. 6, sponsored by Senators Santorum, Frist, Hutchinson, and McConnell, was introduced in the 109<sup>th</sup> Congress. The administration included provisions in their budget of FY2006, but did not include the non-itemizers' deduction.

The Pension Protection Act (P.L. 109-280) included certain provisions of H.R. 7 as noted above, along with lifting contribution caps for conservation and the book inventory provision. It included some other minor benefits along with a number of revenue raising provisions including increased accountability and restrictions for donor advised funds and supporting organizations, arrangements that, like private foundations, permit individuals to direct future charitable distributions from a fund.

While there is no current legislation relating to a deduction for non-itemizers, the President's advisory panel on tax reform has proposed such a deduction along with a 1% floor, which would only allow charitable deductions in excess of 1% of income.