THE TAX POLICY

BRIEFING BOOK

A Citizens' Guide for the
2008 Election and Beyond

TAX EXEMPT ORGANIZATIONS

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Tax-Exempt Organizations: How are charitable contributions treated?

Many types of nonprofit institutions are exempt from paying federal income tax, but only organizations set up under Internal Revenue Code section 501(c)(3) qualify their donors to deduct contributions on their income tax returns. Donations to other nonprofits are made on an after-tax basis.

- Since 1917 individual taxpayers have been able to deduct charitable contributions from income that might otherwise be taxed. Today individuals may deduct cash and certain other contributions up to 50 percent of adjusted gross income (AGI) in a given year and may carry forward any excess for deduction on future tax returns for up to five years. Only taxpayers who choose to itemize may take the charitable deduction. Taxpayers who claim the standard deduction make contributions on an after-tax basis.

- In 1935 Congress extended to corporations the ability to deduct charitable contributions. Corporations may not deduct more than 10 percent of their pretax income in a given year but may also carry forward excess donations for five years.

- Contributions by individuals or corporations may take the form of cash, financial assets, or other noncash property such as real estate, clothing, or artwork. Certain forms of contributions face greater restrictions than do cash contributions, whereas others receive more generous treatment: The limit for donations of appreciated real property is generally 30 percent of AGI, and the limit for contributions to foundations is the same. But donors may deduct the full current market value of appreciated property. This effectively allows the capital gains portion to be deducted twice: donors pay no tax on the capital gain, and then they reduce their other income subject to tax by the amount of the contributed but unrealized income.

- The deductibility of charitable contributions saved individual and corporate taxpayers $104.6 billion in 2006, according to U.S. Treasury estimates.
See Also

Tax-Exempt Organizations: Who benefits from charitable deductions?

Data Sources


Further Reading


Author: Gillian Reynolds and C. Eugene Steuerle
Last Updated: January 21, 2008
Tax-Exempt Organizations: Which entities are exempt?

Nonprofit organizations that do not distribute profits can be exempt from federal income tax if organized expressly for public purposes. Although many different types of nonprofits qualify as tax-exempt, only about 70 percent also qualify to receive tax-deductible contributions, through their status as organizations of "charitable purpose," defined under section 503(c)(3) of the tax code as "religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition [or]...the prevention of cruelty to children or animals." This definition covers both public charities and private foundations, the latter consisting of those organizations created to distribute funds to charities or individuals.

- Tax-exempt organizations include a diverse array of entities, which the National Taxonomy of Exempt Entities (developed by the National Center of Charitable Statistics at the Urban Institute and used by the Internal Revenue Service) classifies into 9 major groups, 26 categories, and over 600 subcategories. The major groups are:
  - Arts, culture, humanities (e.g., art museums, historical societies)
  - Education (e.g., private schools, universities, parent-teacher associations)
  - Environment and animals (e.g., humane societies, the Chesapeake Bay Foundation)
  - Health (e.g., nonprofit hospitals, the American Lung Association)
  - Human services (e.g., the Girl Scouts, the YMCA, food banks, homeless shelters)
  - International and foreign affairs (e.g., CARE, the Asia Society, the International Committee of the Red Cross)
  - Public society benefit (e.g., the Rockefeller Foundation, the Urban Institute, civil rights groups, the United Way)
  - Religion-related (e.g., interfaith coalitions, religious societies)
  - Mutual membership or benefit (e.g., nonprofit credit unions, labor unions, fraternal organizations).

- In 2006 approximately 1.5 million tax-exempt organizations were registered with the IRS (see table). These nonprofits accounted for 5.2 percent of gross domestic product and 8.3 percent of wages and salaries paid in the United States. Far fewer file annual returns (Form 990, 990-EZ, or 990-PF). About 150,000 religious congregations, as well as organizations with less than $25,000 in gross receipts (except for private foundations, all of which must file), do not file annually.

- Tax-exempt status confers multiple benefits. Not only are nonprofits exempt from federal tax on the surplus earned from their income-producing activities, but charities may also sometimes issue federally tax-exempt bonds and are often exempt from state and local property taxes and sales taxes.
See Also

Tax-Exempt Organizations: How are contributions treated?

Tax-Exempt Organizations: Who benefits from the charitable deduction?

Tax-Exempt Organizations: How might incentives for charitable giving be improved?

Data Sources


Authors: C. Eugene Steuerle & Gillian Reynolds
Last Updated: February 14, 2008

Further Reading


Tax-Exempt Organizations: Who benefits from charitable deductions?

A charitable contribution is intended ultimately for the benefit of those whom the charitable activity supports, whether through more educational resources, free health care, or in some other way. If the tax deduction spurs additional giving, charitable organizations may be able to expand and provide additional services. Donors are assisted in their efforts by the charitable deduction, which reduces their own tax liability.

- The charitable deduction subsidizes charitable giving by lowering the cost to the taxpayer of giving. How much the tax deductibility of contributions lowers the cost of giving depends on the donor’s marginal tax rate. For instance, a donor whose marginal tax rate is 30 percent pays 30 cents less tax for every dollar donated.

- Higher-income individuals generally benefit more from the charitable deduction than those with lower incomes for two reasons: they have higher marginal tax rates, and they are more likely to itemize deductions and take advantage of the tax savings. About three-fourths of charitable giving comes directly from individuals, with the balance coming from their foundations, estates, and corporations (see figure). Total contributions totaled more than $260 billion in 2005.

- The tax deductibility of contributions subsidizes charitable activity, but also is justified as an adjustment to the tax base. Many argue that a taxpayer’s tax base should be determined by income net of contributions, since a taxpayer with $50,000 of income and $10,000 of contributions has no more ability to consume than someone with $40,000 of income and no contributions.

- Donors may choose which charitable activities to support. Because part of the cost of their donations is borne by the government through reduced revenue, donors effectively have a say in which activities the government supports.

- Some donations substitute for activities the government might otherwise undertake. Some complement those activities, and still others support an adversarial relationship with government. Nonprofits, for instance, may seek, further government funding for a given activity or its members may engage in debates with government officials. Many believe these multiple types of charitable activity add to the efficient functioning of a democracy even when particular efforts fail.

- Although the tax deduction likely induces additional giving, estimates of the size of this effect vary, and there is considerable debate over whether the increase in giving exceeds the loss of revenue.
See Also

Tax-Exempt Organizations: How are contributions treated?

Data Sources


Author: Gillian Reynolds and C. Eugene Steuerle
Last Updated: January 21, 2008

Further Reading

Cordes, Joseph J., John O’Hare, and C. Eugene Steuerle, "Extending the Charitable Deduction to Nonitemizers," *Charting Civil Society* no. 7 (Washington: The Urban Institute, May 1, 2000).

**Tax-Exempt Organizations: How could incentives for charitable giving be improved?**

Under current law, taxpayers who itemize are allowed to deduct most of their charitable contributions and thus reduce their taxable income and their taxes. Nonitemizers have no comparable tax incentive to donate to charities. In addition, current limitations on deductions reduce existing incentives to donate. Various proposals would restructure tax incentives to encourage more giving.

- One proposal would expand the existing incentive in exchange for a floor on deductions. Incentives are more powerful for the marginal (next, or incremental) dollar of giving than for the first dollars. Consider a person who would give away $1,000 regardless of any incentive but who would give $1,100 if offered a tax incentive to do so. Clearly, an incentive applied to the last $100 of that person’s giving will have a greater effect than one for the first $100 or even $1,000, which will be given anyway. It therefore may make sense to allow deductions only above a floor; the revenue gains from disallowing deductions below the floor could be used to expand other incentives. For instance, nonitemizers who give significant amounts to charity might be allowed to deduct many of their charitable contributions (see below) in combination with a floor under contributions by all taxpayers. The revenue gains from such a floor could be significant: the congressional Joint Committee on Taxation estimated that allowing the deduction only of charitable contributions that exceed 2 percent of adjusted gross income (AGI) would increase federal revenue by nearly $100 billion over five years and about $250 billion over ten years. A much more modest floor would provide substantial revenues that could be used to increase the incentive to give.

- At present, taxpayers who take the standard deduction cannot claim a deduction for charitable giving. Extending the deduction to these nonitemizers would likely increase charitable contributions but might create compliance problems: the Internal Revenue Service cannot reasonably be expected to audit small donations. Also, simply extending the deduction to nonitemizers would increase the complexity of filing in an already complicated income tax system. Many taxpayers would have to calculate taxes two different ways to decide whether they should take their charitable deductions as an itemizer or as a nonitemizer.

- However, if a deduction for nonitemizers were combined with a reasonable floor applied to all taxpayers, much or all of the revenue loss due to noncompliance would be eliminated, as would the added complexity. (Small, merely symbolic floors would not achieve this objective.) For instance, taxpayers might be allowed to claim charitable deductions greater than $500 if they are joint filers ($250 for single filers), regardless of whether they itemize. This combination likely would increase charitable giving at little or no cost in tax revenue and would address concerns about administration and compliance. How much net giving would increase depends upon the sensitivity of giving to incentives (see table).
• Another option would be to raise the limit on deductions for charitable giving above the current 50 percent of AGI. This would significantly increase incentives at the margin for large givers. One could also make carryover provisions with respect to this 50 percent limit more generous. Taxpayers may currently carry over excess contributions to future returns, but only for five years, and any new contributions must be deducted before any carryover.

• Yet another proposal would expand and make permanent the charitable IRA rollover provision. This recently enacted provision, which expired in 2007, allowed some taxpayers over age 70½ to donate up to $100,000 from Individual Retirement Accounts (IRAs) and Roth IRAs to charities without having to count the distributions as taxable income. Restoring this provision and making it permanent, while raising or eliminating the $100,000 annual limit on donations and lowering the age limit to 59½ (the age at which IRA owners may withdraw funds without penalty) could increase charitable giving.

• A final option would eliminate or reform the excise tax on foundation income. The current excise tax on foundations’ income from assets was intended to cover the costs to the IRS of overseeing the tax compliance of charitable organizations, but it has never done so. The tax rate is either 1 or 2 percent, depending on whether giving this year equals or exceeds the average of a few past years. Under these current rules, foundations that make more grants today face a penalty of being more likely to face the 2 percent rate in future years.) Lowering or eliminating the tax would increase the net assets available to give to charitable beneficiaries. Congress could also increase the minimum payouts that a foundation must make by the amount of the tax reduction. At a minimum, Congress could impose a single tax rate on all

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Summary of Revenue Effects and Change in Charitable Giving (Dollar Amounts in Millions), 1995 Income Levels

<table>
<thead>
<tr>
<th>Tax Policy Options</th>
<th>Low</th>
<th>Moderate</th>
<th>High</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Deductions for All Contributions by Nonitemizers</td>
<td>($5,570)</td>
<td>$2,271</td>
<td>($6,215)</td>
</tr>
<tr>
<td>2. Deduction with $500/$250 Floor for Nonitemizers Only</td>
<td>($3,886)</td>
<td>$2,166</td>
<td>($4,518)</td>
</tr>
<tr>
<td>3. Deduction with $500/$250 Floor for All Taxpayers</td>
<td>($1,193)</td>
<td>$1,904</td>
<td>($1,826)</td>
</tr>
<tr>
<td>4. Revenue-Neutral Floor</td>
<td>$650/$325</td>
<td>$1,681</td>
<td>$750/$375</td>
</tr>
</tbody>
</table>

Source: Joseph Cordes, John O'Hare, and Eugene Steuerle, Extending the Charitable Deduction to Nonitemizers: Policy Issues and Options, Charting Civil Society Brief 7, May 2000
such income, to remove the current perverse incentive for foundations to limit current grants today to avoid a higher tax in the future.

See Also
Tax-Exempt Organizations: How are contributions treated?
Tax-Exempt Organizations: Which entities are exempt?
Tax-Exempt Organizations: Who benefits from the charitable deduction?

Further Reading


