Statement for the Record
Committee on Ways and Means
U.S. House of Representatives
Hearing on Tax Reform and Charitable Contributions
February 14, 2013

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Americans For Fair Taxation®

Chairman Camp, Representative Levin, and distinguished Members of the Committee, Americans For Fair Taxation thanks you for the opportunity to submit this statement analyzing the impact of the leading national sales tax plan, "The Fair Tax Act of 2013" (HR 25/ S 122) on charitable contributions and nonprofit organizations. We strongly believe that a shift in taxation based on income to a consumption approach would expand philanthropy by improving economic growth -- the primary determinant of charitable giving. In addition, it would decrease the disincentives to giving now in the Code.

Implicit in the hearing's purpose to "examine[e] the itemized deduction for charitable contributions as part of the Committee's work on comprehensive tax" is the assumption that the itemized deduction must remain after reform. We believe this is a mistake *ab initio*. By taking a tax code provision-by-provision approach to its work, the Committee elevates the Internal Revenue Code, with its established constituencies, beyond the economic or goal-oriented returns for reform in general. The Committee must have the courage not to abdicate its responsibility to reexamine the viability of the current Tax Code in its entirety to determine whether there is a better tool through which we can assure America's prosperity and values into the 21st century, thereby increasing the resources available to nonprofits and the constituents they serve.

Americans For Fair Taxation believes the FairTax Plan is that better tool, because it eliminates the revenue-depleting, lobbying-encouraging deductions and exemptions that poorly serve the economic needs of our Nation today and of charities and their constituents.

Background Discussion

Americans For Fair Taxation recognizes the critical role charities play in maintaining, and in some cases sustaining, the safety net for those in need, and in performing functions that the private sector or government services cannot address or address less well. From centers of learning, to health care facilities, to poverty relief organizations, to public policy research institutions, nonprofits are an indispensable part of the American economic and social landscape. In 2011, Americans contributed $298.42 billion to charitable organizations, religious congregations and other humanitarian causes, even at a time when our economy suffered.[1] We must ensure that our tax system does not hamper the good works of charities or diminish the desire for eleemosynary contributions and volunteerism.

[1] Amy S. Blackwood, Katie L. Roeger, and Sarah L. Pettijohn, The Nonprofit Sector in Brief: Public Charities, Giving, and Volunteering, 2012, The Urban Institute, October 5, 2012, p. 1.

Some say that all of these good things flow from the deduction for charitable contributions. The vast majority of witnesses may say that in so many words. If charitable donations were not tax deductible then charitable giving would diminish; indeed, the financial viability of organizations which rely on those dollars would be threatened. The bedrock argument for this position is that the level of charitable giving in this country has a one-to-one elasticity tied to rates and tax deductions. More specifically still, this theory goes, the steeper the rate of tax, the more pain one feels, the more inclined they are to be giving. As a result, donors become "charitable" when the government gives them a tax break for doing so

But American's charitable spirit is not a result of the charitable deduction. That premise is simply unsupported by the facts. And even if there were truth to the premise that charity is motivated by tax relief, the charitable deduction today is vastly limited in its tax relief compared to it's treatment within the environment proposed by the FairTax.

Fact 1: The Primary Influence on both Large and Small Donors is their Belief in the Charitable Works They Choose to Support.

There is, of course, much anecdotal data. In the early 1900's, before death tax and high marginal rates, the Vanderbilts endowed Vanderbilt University, the Stanfords endowed Stanford University and the Dukes endowed Trinity College in Durham, North Carolina. These may have been different times for sure, but significantly, the empirical data also suggest little linkage then between the tax deduction and nonprofit giving.

A case in point is that after marginal rates were significantly reduced in 1981 and again in 1986 and, after the elimination of the charitable deduction for non-itemizers in 1986, total giving increased, in inflation adjusted dollars, rather than decreased, despite the lowering of marginal income and transfer tax rates. Charitable giving rose by $6.4 billion, or 7.6 percent, in 1987 after the top tax rate fell from 50 to 28 percent (more than doubling the tax price of giving).[2] Likewise, the growth of charitable bequests was most rapid from 1980 to 1987 when estate taxes were coming down.[3]

Furthermore, the vast majority of contributors today do not receive any tax advantage for their donations. The charitable contribution is limited to those who happen to itemize (typically those who are affluent enough to own real estate). According to 2010 data from the IRS on individual returns, only one-third of taxpayers itemized: 46,644,509 itemizers out of 142,892,051 total taxpayers. Since only itemizers may take the charitable contribution, just 33% or one-third of all taxpayers, are even eligible to take the charitable deduction. The relative ratio of itemizers to non-itemizers has remained relatively stable over the years.

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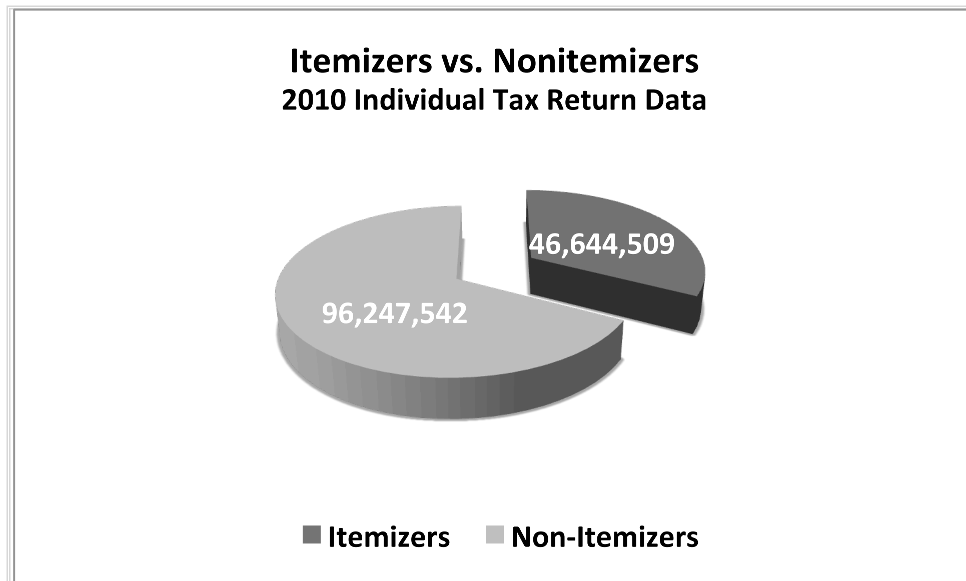
[2] Stephen Moore's response in "Republic of Taxes: When Uncle Sam Takes Do Americans Give?" *Philanthropy Magazine,* Spring, 1997.

[3] Based on federal estate tax returns data reported in Reynolds, Alan, "Death, Taxes and Giving: The Conventional Wisdom and Why it is Wrong," *Philanthropy Magazine*, Winter, 1997.



Fact 2: The Benefit of the Charitable Deduction Goes Overwhelmingly to the Rich.
Upper-income households are the biggest beneficiaries of the charitable deduction, with those making more than $100,000 per year taking 81% of the deduction even though they account for just 13.5% of all U.S. tax returns. The data are even more skewed for households with more than $200,000 of income. They account for fewer than 3% of all tax returns, yet they take 55% of all charitable deductions.

Yet, the facts are that individuals and households of all income levels continue to make contributions to what they deem to be worthy causes. Thus giving is often spontaneous and based on compassionate impulses. The outpouring of financial support to the victims of Hurricane Sandy and the school shooting in Newtown, Connecticut eloquently make this point.

Moreover, the data suggest that contributions are correlated by other factors than the tax deduction. Active civic participation is more important to a healthy nonprofit sector than the presence of any tax credit or deduction. Benefactors are far more influenced by their personal desire to contribute to charitable causes.

Fact 3: Economic Growth is a Major Determinant of Charitable Giving.
It has been said by researchers that as the fortunes of the country go, so go contributions to philanthropic causes. In fact, after years of analysis, the data paints a clear picture: as the Gross Domestic Product changes, so goes approximately 2 percent of the total value of the goods and services to philanthropic causes.

Total philanthropy as a percentage of GDP has held steady at around 2% for at least four decades.[4] This bears repeating: philanthropy as a percentage of GDP has held steady at around 2% ! This has been the case despite the fact that the tax code has changed frequently and

[4] Giving USA, 2012, The Annual Report on Philanthropy for the Year 2011, Executive Summary. Researched and written at The Center on Philanthropy at Indian University, 2012.

dramatically over that time period with the top margin fluctuating between 28 and 91 percent. More specifically, from 1956 through 1972, total charitable giving was consistently at or above 2.0 percent of GDP. However, this percentage fell to an average of 1.85 percent in the period between 1973 and 1996, rising again beginning in 1997. Total giving as a percentage of GDP has been at or above 2.0 percent since that year.

What then is the relationship between giving and income? It has been consistently demonstrated that slight shifts in GDP represent considerable dollars in charitable giving. For example, one quarter of 1 percent of GDP at $15.8 trillion (the estimated 2012 level) equals $156.8 billion. As GDP goes, so eventually does voluntary support.[5]

So the data – as opposed to theory – bear out that this Committee must consider the effect of tax reform on economic growth. It may be counterintuitive to the premise of this hearing, but giving is more dependent on how much donors have to give than how much tax relief the government will provide as a result of those contributions.

<u>Fact 4: The FairTax Plan Will Increase Economic Growth.</u>
One of the most constructive steps that can be taken to improve the rate of economic growth would be to replace the current tax system with a consumption tax. It is the nearly universal opinion of economists that a consumption tax, like the FairTax, would reduce the tax bias against work, savings and investment, improve the productivity and competitiveness of U.S. firms and improve the real wages of American workers. Replacing the income tax with the FairTax will dramatically improve the standard of living of the American people.[6]

Virtually all economic models project a much healthier economy under a broad-based consumption tax such as the FairTax. The FairTax dramatically increases investment levels compared to levels that would have been achieved under the current income tax system.[7] Increased savings will stimulate investment and productivity and the economy will grow more rapidly, creating demand for workers and improving job opportunities. Because taxes on capital are removed, foreign capital will flow into the United States, creating businesses and jobs. U.S. products competing abroad are free of the hidden costs of taxation while the FairTax is collected on foreign products sold in the United States. All of this creates greater wages and income, of which approximately 2%, as history has demonstrated, will likely go to charitable giving.

Those who state that charitable contributions would go down after a consumption based tax must explain why, after eligibility for itemized deductions was constricted, charitable contributions

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[5] Note: Other indicators include the stock market. The trough in giving between 1971 and 1984 coincided with a poorly performing stock market during the 1974-1982 period and two recessions. The dips and rises of the stock market are said to be mirrored by charitable support within a year.

[6] A quote attributable to Maimonides [Moses ben Maimon[(c. 1170) seems particularly apt. "Anticipate charity by preventing poverty; assist the reduced fellowman, either by a considerable gift or sum of money, or by teaching him a trade, or by putting him in the way of business so that he may earn an honest livelihood, and not be forced to the dreadful alternative of holding out his hand for charity. This is the highest step and the summit of charity's golden ladder."

[7] Kotlikoff, Laurence J. and Sabine Jokisch, "Simulating the Dynamic Macroeconomic and Microeconomic Effects of the FairTax," *National Tax Journal*, June 2007; David G. Tuerck, et.al., "The Economic Effects of the FairTax: Results from the Beacon Hill Institute CGE Model," The Beacon Hill Institute at Suffolk University, February 2007.

historically rose.[8] They must also address the issue of economic growth since virtually every economist makes the case that a consumption tax would improve economic prosperity.

Fact 5: The FairTax Will Put More Discretionary Dollars into the Hands of Potential Donors and Facilitate Charitable Giving.

As this Committee considers the itemized deduction, many witnesses can be expected to point out that our income tax system severely restricts the ability of non-itemizers (two-thirds of tax filers) to make charitable contributions. We also make this point, but the solution lies in not imposing any tax on charitable contribution for anyone, and only the FairTax permits that solution.

Dollars a taxpayer must earn to have $100 to donate to charity today

Employment Status	Income Tax Bracket 15%	Income Tax Bracket 28%
Percent of tax returns in bracket	63.47%	21.36%
Employee		
Gross Earnings	$129.28	$155.40
Income Tax	$19.39	$43.51
Payroll tax at 7.65%	$9.89	$11.89
Available to donate	$100.00	$100.00
Self-employed person		
Gross Earnings	$143.47	$176.37
Income Tax	$21.52	$49.38
Payroll tax at 15.3%	$21.95	$26.98
Available to donate	$100.00	$100.00

Note: Self-employed person pay both the employee and employer share of payroll taxes.

Let us consider the effect of the income tax and the payroll tax on the contributions of a taxpayer who does not itemize, but who is in the 28 percent tax bracket shown in the above chart. His or her contribution must by necessity be made from after- income tax and after-payroll tax dollars. The combined effect of the 15.3 percent payroll tax (assuming the employee bears it)[9] and the 28 percent marginal tax bracket means that the taxpayer must earn $176 to make a $100

[8] Steve Moore, Director of Fiscal Policy Studies at the Cato Institute, points out in a Washington Times article (June 18, 1997) that "the last time the [Independent Sector] tried to measure the impact of tax code changes on charities, it predicted that the 1986 Tax Reform Act would trigger an $8 billion decline in charitable contributors in 1987. Instead charitable giving rose by $6.4 billion, or 7.6 percent after the top rate fell from 50 percent to 28 percent."

[9] See The Corporate Income Tax and Workers' Wages: New Evidence from the 50 States, Tax Foundation Special Report No. 169, August 2009; Congressional Budget Office, "Historical Effective Federal Tax Rates, 1979-2006," April 2009 and Joint Committee on Taxation, "Overview of Present Law and Economic Analysis Relating to Marginal Tax Rates and the President's Individual Income Tax Rate Proposals," March 6, 2001.

contribution to charity. In other words, the government effectively imposes a $76 excise tax on the taxpayer's gift to the charitable organization.

For taxpayers who do itemize, the donor is able to make the gift before income tax, but only after payroll taxes. The U.S. Office of Management and Budget estimates the total tax revenues lost from charitable contributions[10] (known in tax jargon as tax expenditures) to be $4.61 billion for education, $4.49 billion for health, and $39.77 billion for other purposes, for a total of about $48.87 billion. But as large as this tax expenditure estimate is (and as unlikely therefore that this Committee will allow an above-the-line deduction in the current deficit environment), the charitable contribution only off-sets one type of tax the itemizer pays among total tax liability. The tax expenditure would be significantly greater if it permitted a deduction against payroll taxes.

These payroll taxes, be they employer- and employee-combined payroll taxes or self-employment taxes (paid by our nation's more than 17 million entrepreneurs), comprise a significant segment of the taxes Americans pay today. As a national aggregate, in 2011 individual income taxes were $1,091.5 billion. Payroll taxes were $818.8 billion, or 43 percent of the combined total. Many taxpayers, especially lower income individuals, pay a greater portion of their tax liability in payroll taxes as opposed to income taxes. In fact, over 55 percent of individuals at the bottom 40% of the income distribution had a payroll tax liability that exceeded their income tax liability in 2011.[11]

To illustrate how limited the charitable deduction benefit for itemizers is today, consider a married couple earning $58,840 (two times the poverty level) in 2011. If that income were all wage income, then that couple would have paid $9,002 in combined payroll taxes on those wages (employer and employee share). If that couple did not itemize, the maximum income taxes that they would pay if they filed married-filing-jointly would be $5,126 or 43 percent less than their payroll taxes.[12] In other words, the couple would have paid more payroll taxes than income taxes. That holds true even if that couple itemized, and the couple were to take a charitable contribution deduction. The bottom line" the couple *cannot* take that deduction against the most significant form of taxes that apply to them -- payroll taxes. A taxpayer today must earn at least $108.28 to contribute $100 if only the "employee" share of the payroll taxes is considered, even if the charitable deduction is fully taken.

An interaction of complex additional restrictions apply to further erode the benefit of the deduction. For example, if a donor contributes appreciated property that is considered "ordinary income-type property,"[13] as opposed to long term capital gain, the donor must reduce the gift by the amount of ordinary income that would have been recognized if the property were sold. Hence, gifts of inventory, art works, letters and other similar property created by or for the taxpayer, are generally severely limited to exclude appreciation.

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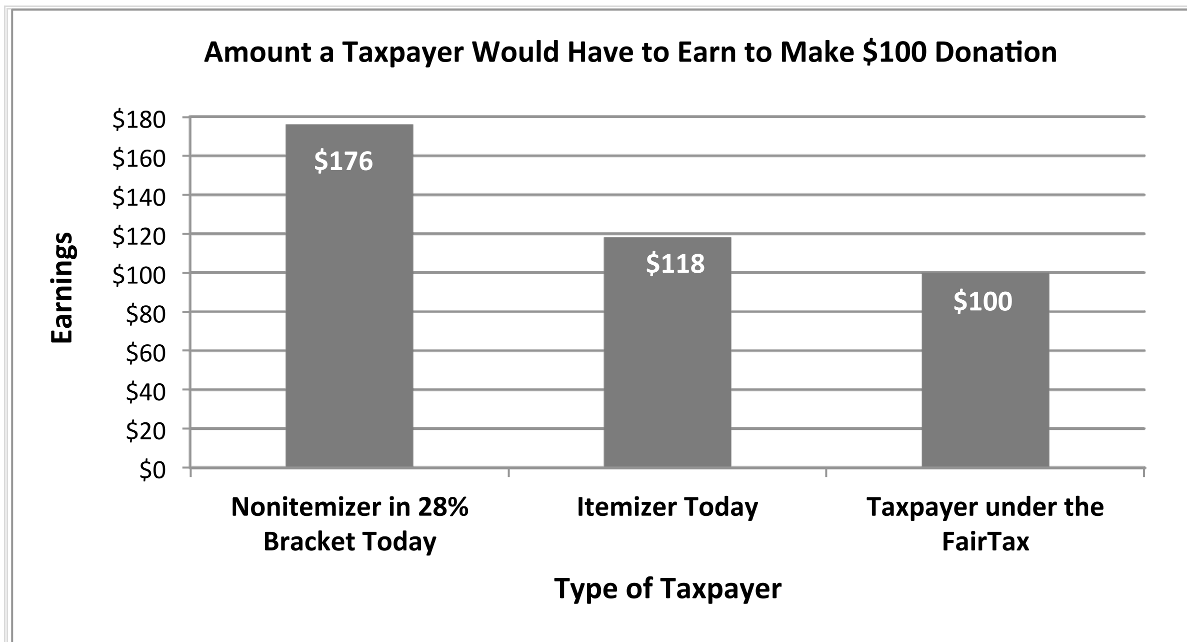
[10] Analytical Perspectives, Budget of the U.S. Government, Fiscal Year 2013, Table 17.4.
[11] Source: Urban-Brookings Tax Policy Center Microsimulation Model. June 17, 2011.
[12] $58,840 - $11,600 (standard deduction for married filing jointly) = $47,240. Subtracting two personal exemptions at 3,700 each leaves taxable income of $39,840. The income tax on taxable income of $39,840 = $5,126.
[13]This provision is defined in Internal Revenue Code section 170(a) and the regulations thereunder.

The needless complexity of our antiquated tax code for charities does not stop there. Corporations are limited when making contributions of inventory or depreciable real property to one-half of the ordinary gain that would have been realized if sold.[14] Moreover, the value of gifts of tangible personal property and gifts to certain private foundations must be reduced by the "total amount of the gain that would have been long-term capital gain if the property were sold for its then fair market value on the date it was contributed".[15] Furthermore, individuals are subject to a deduction ceiling based on the type of property contributed and the type of charity to which the contribution is made—a ceiling that can be as low as 20 percent of the individual's adjusted gross income. And these are just a few of the restrictions.

Now let us consider what happens under the FairTax consumption tax. Under the FairTax, charitable contributions are simply not taxed. That bears repeating: they are not taxed at all! They are neither taxed to current itemizers nor to non-itemizers. Therefore, like current law, donors would donate earnings out of pre-income-tax dollars. More to the point, since the FairTax repeals both the payroll taxes and the income taxes, the effect of not taxing their contributions is to ensure that the payments are made with both pre-income and pre-payroll tax dollars.

The relative advantage of allowing a deduction against income vs. not taxing income or wages is depicted in the graph below which demonstrates that the cost of charitable giving will actually go down considerably under the FairTax.



In order for this Committee to retune the income tax charitable contribution to match the power of the FairTax for charities, it would have to do a couple things: (1) it would have to allow for an

[14] This complex provision is contained in IRC section 170(e)(3).
[15] IRC section 170(e)(1).

above-the-line deduction so that the two-thirds of taxpayers who do not itemize can take the deduction, (2) it would have to allow the deduction against payroll taxes for both itemizers and non-itemizers. Ask yourself this question: how prepared is the Committee to make those changes?

With the adoption of the FairTax, corporations may also become major contributors to charity. Under the current system, total charitable contributions for corporations may not exceed 10 percent of taxable income. Eliminating this limitation will enable corporations to give more generously.

Fact 6: The Relative Cost of Capital Will Not Rise Under the FairTax.

Charitable giving represents a significant and thankfully growing outlay. In 2010, total charitable giving as measured by the charitable deduction was estimated to be $170.2 billion or 80.4 percent of the $211.8 billion in total charitable giving estimated by Giving USA. However, it is important to bear in mind that individual charitable contributions, while certainly important, are only a portion—and not a major portion -- of the resources that fund charitable organizations today.

The major source of nonprofit income is not contributions at all, but rather program service fees from both private and government sources. According to the 2012 Nonprofit Almanac, nonprofit organizations contributed $804.8 billion to the U.S. economy in 2010, making up 5.5 percent of the country's Gross Domestic Product (GDP). The nonprofit sector has grown steadily and significantly since 1985, outpacing GDP growth. Total expenses reported by nonprofits showed a cumulative real growth of 118 percent between 1985 and 2008. Over the same period, cumulative growth in GDP measured 67 percent.[16]

Moreover, all tax-exempt nonprofits, and particularly 501(c)(3) nonprofits,[17] are increasingly reliant on commercially oriented as opposed to donation oriented sources of income. This activity is concentrated in the largest nonprofits. When nonprofits rely on commercial sources of revenue, they derive that revenue primarily from the service industries. On this income, little tax is paid either because the nonprofits declare the income as substantially related to their exempt function or because they are able to successfully allocate deductions to the unrelated income.

The chart below places this in perspective. In 2010, public charities reported $1.5 trillion in revenues and $2.71 trillion in assets, accounting for nearly three-quarters of total nonprofit sector revenue and over 60 percent of all nonprofit sector assets. As a percentage of total revenues, private contributions accounted for just 13 percent of revenues in contrast to program services which made up 74 percent of revenues. Program service fees from government sources were 24 percent and those from private sources accounted for 50 percent of total revenues, respectively.[18]

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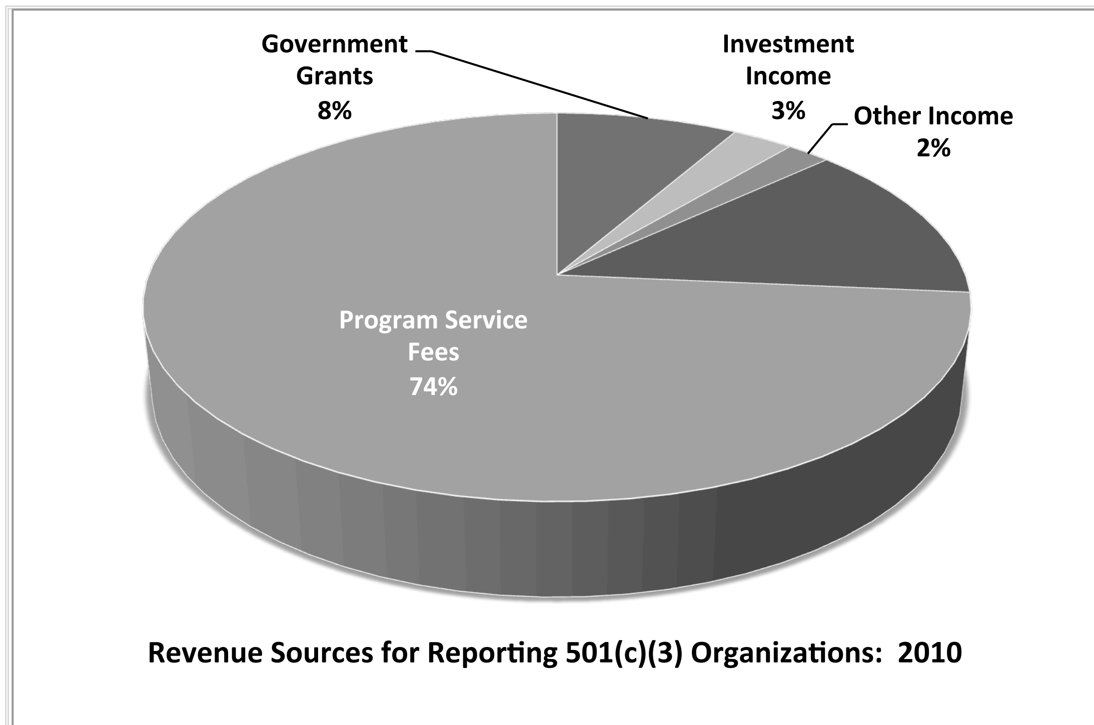
[16] IRS Statistics of Income.

[17] Of the more than 30 types of nonprofit organizations defined by the Internal Revenue Code, 501(c)(3)s make up nearly two-thirds of nonprofits. These are: religious, educational, charitable, scientific or literary organizations, testing for public safety organizations, etc. When we refer to "nonprofits" as opposed to other tax-exempt organizations, we generally refer to these as 501(c)(3)s.

[18] Amy S. Blackwood, Katie L. Roeger, and Sarah L. Pettijohn, The Nonprofit Sector in Brief: Public Charities, Giving, and Volunteering, 2012, The Urban Institute, October 5, 2012, p. 3.



There is a steady increase in reliance on "program service revenue" as the size of the nonprofit organization, measured by asset holding or gross income, increases. According to IRS data for 2008, nonprofit organizations with assets of $50 million and above rely on contributions, gifts and grants for only 16 percent or their income in 2008.[19] This can be contrasted with organizations with under $100,000 in assets, which relied on gifts, grants and other contributions for 36 percent of their revenue. The $50 million asset group derived 84 percent of their income from "program service revenue" whereas the nonprofits with less than $100,000 in total assets relied on these revenues for 54 percent of total revenues.

Additionally, commercial type activity is concentrated in 501(c)(3)s. Gross profits from sales and service is the largest source of income for 501(c)(3)s. If income is "substantially related" to the exempt purpose, it is not considered unrelated business income activity and is wholly exempted from taxation. While the taxes paid by nonprofits have increased over the last decade, the increase has not kept pace with the growth of nonprofit's commercial sources of revenue.

The FairTax consumption tax would not alter the non-contribution resource base of nonprofit organizations. If the nonprofit earns income that is program service revenue, it is not taxable. It should also be pointed out that if the nonprofit earns unrelated business income—income that is not substantially related to its exempt purpose—that income would also be tax-free to the nonprofit under the FairTax.

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[19] Internal Revenue Service, Tax Statistics, Charitable and Exempt Organization Statistics, Table 1—Selected Form 990 Data for 501(c)(3) Organizations, 2009.

Conclusion

Some 150 years ago, Alexis de Tocqueville wrote: “The greatness of America lies not in being more enlightened than any other nation, but rather in her ability to repair her faults.” Today, America’s financial well-being is threatened by its continued reliance on an antiquated regimen of tax laws and regulations to generate the revenue needed to support our government’s spending priorities. Many of these provisions served their purpose when enacted and implemented. For most, that time has passed.

Our Nation is faced with a fiscal crisis, in no small part as a direct result of Congressional inaction. The Committee has an historic opportunity to right this wrong and in so doing, demonstrate that it has the courage to lead rather than follow.

Americans for Fair Taxation maintains that the FairTax is the path forward. When it comes to charitable giving, the empirical data—the facts—support its positive impact on charitable and philanthropic giving by improving the primary determinants of charitable giving—economic growth and real income.