The Worthy Tax Expenditure

Prepared for the Nonprofit Forum
By Catherine E. Livingston
Caplin and Drysdale, Chartered

Author's Note: This is a work in progress. The author gratefully accepts criticism of the central thesis (hoping that it is intelligible) and suggestions on how it can be better developed.

Considerable thought and energy has been devoted to debating whether or not the tax code should contain "tax expenditures." The concept of a tax expenditure was originally advanced by Stanley Surrey and Paul McDaniel. It has since been memorialized in federal law in connection with the statutory requirements for the budget process. The statutory definition states that tax expenditures are

> revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.[1]

As Surrey and McDaniel have explained, such provisions

> are departures from the normal tax structure and are designed to favor a particular industry, activity, or class of persons. They take many forms, such as permanent exclusions from income, deductions, deferrals of tax liabilities, credits against tax, or special rates. Whatever their form, these departures from the normative tax structure represent government spending for favored activities for groups, effected through the tax system rather than through direct grants, loans, or other forms of government assistance.[2]

Nonprofit organizations have several reasons to be keenly interested in tax expenditures: (a) they are beneficiaries of some of the most significant ones currently in the Internal Revenue Code (the "Code"),[3] and (b) tax expenditures are frequently being proposed to accomplish certain social welfare objectives that have traditionally been the province of charities.

Economists and others have thought extensively about the merits of tax expenditures in general, and of the charitable contribution deduction in particular. They have used econometric analysis to determine whether the societal gains generated by this

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[1] The Congressional Budget and Impoundment Control Act of 1974 (P.L. 93-344), sec. 3(3); 2 U.S.C. § 622(3).

[2] Stanley S. Surrey and Paul R. McDaniel, Tax Expenditures (Cambridge 1985), 3.

[3] The President's Budget for FY2000 lists deductibility of charitable contributions as the eighth largest tax expenditure, costing approximately $25 billion.

tax expenditure offset the lost revenue.[4] Less time has been spent on the merits of the charitable contribution deduction as a tax rather than a direct expenditure. Surrey and McDaniel note that theoretically, tax and direct spending can be the same thing. "A refundable taxable credit and a direct grant program can produce identical results in terms of beneficiaries, distribution of benefits, and desired objectives. . . . The principal factors that remain to affect the choice between tax expenditures and direct spending programs are the agency that will run the program and the congressional committee that will exercise jurisdiction over the program."[5]

This paper uses a comparative analysis to unearth the merits and deficits of various tax expenditures for the nonprofit sector. The Clinton Administration has provided a rich supply of examples to be analyzed. The budget politics of recent years have prevented the enactment of virtually any new spending programs while favoring anything that can be styled as a tax cut. In response, the Clinton Administration has advanced spending initiatives by dressing them up as "targeted tax cuts." Comparative analysis leads to the conclusion that the charitable contribution deduction is highly unusual and stands nearly alone as a successful tax expenditure benefiting the nonprofit sector, the worthy tax expenditure, if you will. Most of the other tax expenditures that have been touted as benefiting nonprofits are or would be deeply problematic because

(1) they are complex and impose burdensome administrative costs on nonprofits and the IRS; and
(2) they enable politicians to claim credit for addressing a societal need when the individuals or entities most in need of help are unlikely to benefit from the expenditures being made.

In short, with the exception of the charitable contribution deduction, tax expenditures for nonprofits and charitable constituencies are generally less desirable than direct expenditures. Favorable experience with the charitable contribution deduction should not lead nonprofits to see the tax system as an efficient or effective tool to fund social welfare work. A proliferation of tax expenditures sold to the public under the illusion that they equal true government social programs will increase resistance to the outright spending that could actually do some good and will undermine the ability of the tax system to do what nonprofits need it to do: provide charities with vital broad-based financing and public support and maintain their credibility as altruistic actors. Nevertheless, the flaws of the many other tax expenditures that ostensibly benefit nonprofits should not detract from the power of the charitable contribution deduction. It would not be possible to replace it with a direct expenditure without sacrificing key support for our democratic system. It has proved its worth in our tax system, and any broom used to sweep out needlessly complex and inefficient tax expenditures should not be allowed to clean it away.

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[4] See, e.g. Charles Clotfelter, "The Economics of Giving" in John W. Barry and Bruno V. Manno (eds.), Giving Better, Giving Smarter: Working Papers of the National Commission on Philanthropy and Civic Renewal, Washington, D.C.: (1997) pp. 31-35.

[5] Surrey and McDaniel, 117.

A. Tax expenditures can impose burdensome administrative costs on nonprofits and the IRS

Our income tax system works best when the IRS is able to determine compliance by automatically matching financial transactions with tax returns. Tax expenditures that are based on fuzzy concepts like disability or educational status do not fit this model neatly. Moreover, the size of the tax benefits can invite fraud, and the complexity of the criteria for eligibility make the provisions hard to explain to taxpayers. The IRS does not have the expertise to evaluate eligibility, so third parties get dragged in to the system to serve that function. Were these direct expenditures, an agency with the appropriate expertise would ensure compliance and assist potential beneficiaries by taking applications, and awarding funds only after having verified eligibility. IRS enforcement must be done after taxpayers have helped themselves to these benefits, and the difficulty of determining compliance, and, in the case of tax-exempt bonds, the consequences of taking the benefit away after the taxpayer has claimed it, make tax expenditures very difficult to administer.

The Hope and Lifetime Learning Credits are sterling examples of tax expenditures that create substantial administrative costs for the government and for nonprofits. Because the credits are large (the maximum Hope Credit for 1999 is $1500 per student and the maximum Lifetime Learning Credit is $1000 per taxpayer.), individuals would have a strong incentive to cheat and claim the credits even though they were not paying tuition for themselves or their immediate family members. The eligibility criteria were also sufficiently complicated that families would need a report to verify that they were paying tuition to the right type of institution, that the student had the proper enrollment status, and that the right amount of tuition and fees were claimed as the base for the credit. To prevent fraud and help families actually use the credit, it was necessary to require information reporting by the institutions receiving tuition payments. The estimate for the revenue cost of eliminating information reporting is approximately $6 billion over 10 years, reflecting the projected cost of fraud and noncompliance without information reporting.[6]

Specifically, new section 6050S of the Code requires higher education institutions – nonprofit, for-profit and public – to report several pieces of information about each student to the IRS annually and to provide a corresponding statement to the student, and the student's parents if they are claiming the student as a dependent for tax purposes. The information is placed on the return 1099-T. The information required is as follows:

(1) the name, address and social security number of the student
(2) the name, address and social security number of whoever will claim the student as a dependent,
(3) the aggregated payments for qualified tuition and related expenses received with respect to the student during the year,
(4) the amount of any grant received by the student for payment of costs of attendance and processed by the institution

[6] Joint Committee on Taxation estimate provided to Senator Susan Collins, May 7, 1998.

(5) the aggregate amount of reimbursements or refunds paid to the student during the year by the institution, and
(6) any other information required by the IRS.

Reports must be provided with respect to every student except

- Students enrolled exclusively in non-credit courses
- Students whose net out-of-pocket payment for qualified tuition and related expenses is zero
- Students who are nonresident aliens (unless they have requested information reporting)

The cost per student is modest in comparison to the benefit the student receives, a benefit that presumably flows through to the institution because it subsidizes tuition. However, implementing a reporting system entails considerable time, effort and frustration. First of all, some of the information requested – specifically the parents' SSN – is not collected by colleges and universities for any other purpose. Individuals are often sensitive about releasing this information, and colleges and universities have no desire to collect it or keep it, but for this reporting requirement.[7] The IRS needs the information because its antiquated computer system cannot match an information return to a tax return where the individual covered by the information report appears as a dependent. Second, every college and university follows its own billing system and labels its charges however it sees fit. Determining which charges constitute qualified tuition and related expenses is no simple task. Granted, students will need this information in order to calculate their credits so the reporting requirement is forcing the institutions to understand rules they will need to master later, but the reporting also necessitates systems changes so that the information can be stored and reported as required. When those requirements are added to work being done on Y2K issues and other institutional needs, it becomes an overwhelming task. More than one business has offered to handle the information reporting for a fee. Although this solves the problem of the administrative burden, it can increase the financial burden on the institution. Making this tax expenditure work requires the IRS and third parties – namely the institutions – to build systems that would not otherwise exist, simply to manage compliance.

Tax-exempt bond financing is another tax expenditure that entails significant administrative costs. In order for a nonprofit to benefit from this subsidy for borrowing, it must obtain a host of legal opinions on compliance with very complex rules, including bond arbitrage and private use of bond-financed facilities. (Contrast the expertise needed to take advantage of this tax expenditure with that needed to invoke the charitable contribution deduction. One can be used only with the assistance of highly skilled accountants and investment bankers. The other can be used by any individual able to make a contribution.) The new Tax-Exempt and Governmental Entities Division of the IRS has been charged with responsibility for monitoring compliance. The Exempt

[7] Under simplified reporting requirements that have been put in place pending the issuance of regulations, institutions are not required to collect or report information about parents. See Notice 97-73, 1997-51 IRB 16; Notice 99-37, 1999-30 IRB 124.

Organizations Division has struggled to implement an audit program. After-the-fact enforcement is extremely sensitive because the mere existence of an IRS inquiry into a bond issue can have adverse effects in the bond market, potentially "blowing up" the bonds at great cost to the nonprofit borrower. Pushed by a Congressional directive in the IRS restructuring legislation,[8] the IRS has been trying to establish a fair appeals process, but it remains to be seen whether it can be made to work. Taking away the tax expenditure after it has been claimed has a huge adverse impact not only on financial markets for the bonds but also on the infrastructure projects the bonds fund. A direct expenditure system would not eliminate the risk of arbitrage so it would not necessarily solve the complexity problem, but it might create a general deterrent to abuse by forcing all borrowers to identify themselves to the regulators before issuing bonds.

The long-term care credit that the Clinton administration has proposed in its most recent budget would benefit a constituency certain nonprofits try to help – the disabled and their families – rather than the nonprofits themselves. A credit of $1000 would be available to each disabled individual needing long-term care or to an individual with respect to a disabled spouse or dependent child. Implementing it will require the IRS to untangle a knot of technical requirements and gain expertise far outside the area of tax administration. In order to qualify for the credit, the disabled person receiving care must have problems that impair at least 3 activities of daily living although alternative tests are available for those who may be a threat to themselves or others. Monitoring compliance would require the IRS to determine whether or not individuals are sufficiently disabled to qualify for the credit. Individuals would be required to get a physician's certification, and to supply the unique physician identification number provided through the Medicare system. Verifying the numbers alone requires coordination with another agency. The Department of Veterans' Affairs and the Social Security Administration have expertise in reviewing claims for disability, but borrowing that expertise would result in disclosure of confidential return information. Admittedly, the Code already contains a credit in IRC § 22 for the permanently or totally disabled,[9] so the IRS already needs some disability expertise, and IRC § 7702B(c)(2)(B) defines activities of daily living,[10] but the existence of these definitions just highlights the coordination the IRS must do between this new proposed credit, existing credits for the disabled, and the treatment of long-term care insurance. Administering this credit is no simple affair. The complexity of the criteria also means that taxpayers will make many more honest mistakes that the IRS must address.

By contrast, administration of the charitable contribution deduction can be reasonably efficient and effective because the eligibility criteria are measured in dollars and cents and the eligible donees have historically been recorded by the IRS for other

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[8] Internal Revenue Service Restructuring and Reform Act of 1998, P.L. 105-206, 112 Stat. 685 § 3105; Rev. Proc. 99-35, 1999-35 IRB ___.

[9] A person is totally or permanently disabled if he is "unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment." IRC § 22(e)(3).

[10] The activities listed are eating, toileting, transferring, bathing, dressing and continence.

purposes under the Code. [11] (The significance of these historical practices cannot be underestimated in a government as large as ours where shifting responsibilities can be difficulty and costly.) Other criteria like the need to itemize deductions and the percentage limitations are mathematical calculations or aspects of tax administration that the IRS routinely handles as part of its core mission. Because the IRS already identifies nongovernmental, non-church charitable donees for purposes of granting tax exemptions, it has most of the information it needs to check compliance. No expertise outside the IRS is needed. Section 170(f)(8) did have to be added to protect against abuse, but it does not require additional filings with the IRS. In many cases, the requirements could be met by adding a modest amount of language to gift receipts charities were already providing.

There are other tax expenditures that share these virtues and can be administered smoothly. For example, the student loan interest deduction provided by section 221 is based on a financial transaction that can be readily tracked. Once Congress eliminated the option for deducting interest on mixed use loans that were used in part for education and in part for other purposes,[12] identifying a student loan became a straightforward matter. The principal remaining complexity in the deduction – limiting the deductible interest to that paid during the first 60 months interest payments are required – was added to the law simply to reduce the revenue costs. The Administration and members of Congress have both proposed eliminating it to make the deduction workable. The exclusion for employer-provided educational assistance provided under section 127 is another example of a tax expenditure that functions smoothly. There is a clear dollar limit on the amount employers may provide tax free. Employers do not need to evaluate the subject matter of the courses, or any other educational matter that would require special expertise, and they do not need to do any special reporting either.

Although there is an intense scholarly debate over the efficiency of the section 170 deduction as a stimulant for charitable giving,[13] it seems clear that it would be far more costly from an administrative perspective to have a direct spending program than to have the tax expenditure. Either the expert staff at the IRS would have to be duplicated in another agency, or the IRS staff would have to be expanded to have the time necessary to review applications for grants and make selections among them. Furthermore, determining how to divide the subsidy and the standards for awarding grants would be very cumbersome and time-consuming. Should a grant be based on the number of contributors to the organization? the value of contributions? the type of work the charity does? Its history of effectiveness in doing its work? Private foundations and other grantmakers face these questions all the time and expend considerable effort in answering them, but they only have to satisfy the concerns of their founders or boards, not the full

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[11] There are exceptions. A charitable contribution deduction is available for a gift to a church, and churches are not required to apply to the IRS for recognition of their exempt status. Similarly, a deduction is available for a gift to federal, state or local government, and governmental entities are not required to register with the IRS. Nevertheless, the IRS has managed to review contributions to churches and government sufficiently to make the deduction workable.

[12] Public Law 105-206, § 6004(b)(1).

[13] See note 4, supra.

range of charitable interests in the entire country. Formidable machinery would have to be built to distribute funds that now are disbursed by being attached to individual contributions at little administrative cost to the government.

II. Political Credit but Little Real Benefit to the Nonprofits and Poor Individuals who Could Use the Help

Tax expenditures can have large price tags. Politicians use the projected revenue loss to claim credit for having addressed social problems, saying they have "spent" millions or even billions of dollars. However, depending upon the design of the tax expenditure, they may be claiming credit for something that will not accomplish its ostensible purpose. Not being technical tax experts, the politicians do not always appreciate these flaws. Once they have spent money through a tax expenditure, they will resist the direct spending programs with similar objectives that actually could do the job.

Of necessity, nonrefundable tax credits can benefit only those who pay taxes. Therefore, income tax credits are of no immediate use to tax-exempt organizations. Proposals have been made to allow tax-exempt organizations to use their credits against employment tax liabilities, but there are problems with that approach. It would necessarily add complexity because it would involve another agency, the Social Security Administration. Taxable organizations without tax liability would demand the same benefit. And it would increase the burden on the government of funding retirement liabilities for the nonprofit's employees because they would be entitled to the same benefits even though their employer had not made equal contributions.

Often, it is the nonprofit with the will and expertise to do the project that earns the credit, but it is the for-profit that has the capital to fund the project and the interest in reaping the tax benefit. To solve this problem, attempts have been made to transfer the benefits of tax credits from taxpaying corporations and businesses to tax-exempt organizations through syndication and partnerships. For the low-income housing credit, these arrangements have been largely successful because the credit is based on dollars spent for housing structures that meet certain requirements. The credits can be allocated to the partners in the partnership as any other item of income would be. However, it's not so easy to do this special allocation for the welfare to work or work opportunity tax credits. The taxable organizations have job openings but are often reluctant to hire former welfare recipients and other targeted groups because they can require special training and management. Nonprofits that are dedicated to helping former welfare recipients return to work as part of their charitable mission are eager to hire these people and help them adjust to a work culture, but they lack the funds necessary to expand their payroll. Attempts have been made to form a partnership to which the for profits contribute capital which is used by the nonprofits to hire targeted individuals. In turn, the nonprofits are supposed to make the credits they cannot use available to their taxable partners. The scheme is flawed because the taxpayer claiming the credit must be the employer of the targeted person, and the nonprofits cannot transfer that relationship to their partners.

Similarly, income tax credits are of no immediate use to individuals who have too little income to owe income tax. The alternative minimum tax, and the combination of credits mean that there is little in the way of benefit for the poor whom many charities seek to help. The taxpayer may be technically eligible for a wide variety of child credits, child care credits, earned income tax credits, but cannot use nearly all of them because they do not have enough tax liability or because the credits may not be used against the alternative minimum tax.[14]

For individuals, the problem can be solved by making the tax credit refundable, as the earned income tax credit (EITC) is. However, experience with the EITC demonstrates that refundable tax credits pose substantial risks for the tax system. They can be an invitation for fraud, and the administrative machinery necessary to stop that fraud can be expensive. The EITC has been the subject of a GAO investigation and repeated Congressional inquiries.[15] To combat some of the fraud that has been found, the Code has been repeatedly amended to add taxpayer identification number requirements, math error procedures, and due diligence procedures for return preparers doing returns with an EITC claim.[16] This in turn has necessitated creation of special procedures to offer TINs to those otherwise not eligible to receive SSNs. This isn't to say that the benefits do not offset the risks, but administering a refundable credit to provide the benefits to those truly in need can be quite difficult.

The charitable contribution deduction could be criticized for lack of efficiency in delivering benefits to nonprofits, but the nonprofit sector generally views it as beneficial. What it may not collect in contributions directly attributable to the deduction, it more than recoups from the public support the deduction symbolizes and encourages. Nonprofits use it to drive fundraising campaigns, and tax returns effectively provide free advertising promoting charitable contributions. Perhaps the same could be said about the Hope Credit as an affirmation of the value of higher education, but that value is meaningless to people who cannot afford to attend college. Also, the charitable contribution deduction offers predictability. Donors usually know whether they will itemize, and very few are constrained by the percentage limitations. When donors know what to expect, it gives the deduction the capacity to influence behavior. Many other tax expenditures lack predictability because of the complex eligibility criteria combined with income phase-outs and AMT limitations.

What's more, as a tax expenditure rather than a direct expenditure, it provides a counterweight to the majority-based decisionmaking that otherwise allocates funds for

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[14] Recent tax legislation has attempted to address this problem. See H.R. 2488, The Taxpayer Refund and Relief Act of 1999, § 121 (making nonrefundable credits available against the AMT).

[15] United States General Accounting Office, "Earned Income Credit: IRS' Tax Year 1994 compliance Study and Recent Efforts to Reduce Noncompliance," Report to the Chairman, Committee on Way s and Means, House of Representatives and to the Honorable Larry E. Craig, U.S. Senate.

[16] See P.L. 103-465 § 742(a) (TIN requirements); P.L. 104-193 § 451(c) (math error procedures; P.L. 105-34 § 1085 (due diligence)

spending programs. And it reinforces the value of participation in a democracy by giving a benefit to individuals who take the initiative to support voluntary associations. The genius of the charitable contribution deduction is that it lets donors vote with their checkbooks. No particular kind of charitable activity, or social viewpoint is favored over any other. How can we say that a homeless shelter is more important to a community than a research university? Organizations representing both majority and minority viewpoints can flourish side by side. In these respects, the tax expenditure delivers more effectively than a direct expenditure ever could.

Thus, unlike many other tax expenditures that make a nice sound bite or campaign promise but cannot deliver as anticipated, the charitable contribution deduction really does fuel charitable activity. Its supporters deserve the political credit they receive for supporting the nonprofit sector.

Conclusion

This analysis should tell the nonprofit community not to be enchanted by tax expenditure proposals offered by well-meaning politicians who want to help the nonprofit sector. Tax expenditures to accomplish social welfare objectives, like making child care affordable or funding institutions that serve the poor, are not a substitute for direct spending programs. Recognizing that current budget politics block the initiation of most new spending programs or the expansion of existing ones, nonprofits should still resist the lure of tax expenditures that can actually harm the tax system and the nonprofit sector.

Nonprofits should be concerned about statutory provisions that set the IRS up for failure. In recent years, politicians have pointed to IRS enforcement failures as a way to stimulate hostility against the agency, block necessary increases in funding and restrict the IRS's capacity to collect revenues. The EITC is a favorite target as presumably will be tax expenditures proposed by the party that is not the majority in Congress. Naturally the IRS has difficulty enforcing the law when enforcement requires expertise or information it does not have. Nonprofits should worry about setting the IRS up for failure because charities would suffer greatly without IRS oversight to maintain public confidence in the charitable sector.

A direct spending program would not be a substitute for the charitable contribution deduction. Government officials decide how to distribute the dollars in a direct spending program, constrained only by Congress's directions – which are decided by majority vote – or by personal preferences. Nonprofits that take positions consistently rejected by the majority or by the officials distributing funds would never be able to attract the subsidies that the tax system attaches to each deductible contribution they receive from an individual supporter. Nor could a spending program distribute funds as swiftly and easily as the section 170 tax expenditure does. Charitable donees do not have to fill out applications, answer to site visitors, or otherwise ingratiate themselves with

government representatives. As long as they can satisfy their private donors, they get a subsidy in the form of larger donations. For these reasons, the charitable contribution deduction has unique value as a tax expenditure. Any efforts at tax reform should seek to retain it, rather than rejecting it simply because it is a tax expenditure rather than a tool for measuring income in a pure Haig-Simons sense. Our society benefits from a strong nonprofit sector, and a tax expenditure is the best way government can support the sector.