**111th NTA Annual Conference on Taxation**
**Thursday, November 15, 2018**
**3:45 pm – 5:15 pm**

# Discussant Comments

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*Commenting on:*
The Tax Expenditure for Tax Exempt and Charitable Organizations
By Nathan Born & Adam Looney

***My Observations on the Paper Itself***

I much appreciate this paper for its contribution to our understanding of how tax expenditures for the tax-exempt sector presently work. The authors' valuation of tax-exempt status and observations of the most-benefited organizations enable a more nuanced examination of tax ramifications going forward.

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First, an observation: in 2010, tax-exempt organizations represented over 5 percent of U.S. G.D.P.[1] As such, an attempt to determine the extent of support through the favorable tax treatment accorded through tax-exempt status and individual deductions seems long overdue.

Now, a reminder: when Congress allocates a direct subsidy such as a Departmental appropriation, the affected agency is required in some public procedural setting to establish the link between the monies and the economic and/or social policy being promoted. In contrast, an indirect subsidy—in the form of an exclusion, deduction, or credit for income tax purposes —is not generally subject to the same transparency. The tax law-making process is much more opaque. Yet, whether direct or indirect, the value of the subsidy is revenue foregone. The combination of *providing* organizations tax-exempt status and *allowing* individuals deductions for contributing to them unquestionably constitutes a governmental subsidy, even though the support is indirect.

Evaluations of indirect subsidies remain, as this paper reminds us, a relatively incomplete process. Valuing tax expenditures may only be traced to 1970, prior to which no systematic assessment linking an articulated policy and a given tax expenditure was undertaken. This paper steps into an undertheorized area, the tax-exempt sector, and makes an important contribution to tax literature by newly estimating the expenditure's revenue cost through:

> Income Exclusion As income excluded by tax-exempt organizations is not reported, the paper evaluates the exclusion by recasting a sample of non-charitable tax-exempt organizations as Subchapter C corporations. By determining an organization's potential financial performance, the paper appraises excluded earnings as forgone tax revenue.
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> Charitable Deduction The paper has a twofold analysis of the charitable deduction. It looks to the deduction itself: claims for cash, non-cash, and carryover amounts. Then, it examines the treatment of excluding of capital gains on contributed assets, which is not currently estimated in tax expenditures, by using cost-basis and market value data.

Through this novel model, the authors are able to reach unprecedented determinations. For instance, the paper shows that the benefit of the indirect expenditure is less pronounced for organizations relying on cash or contributions of household property rather than stock having an appreciated value. I will not attempt to comment on the methodology used by the authors in this study. Instead, I choose to review its potential use in the continuing effort to efficaciously incorporate the tax-exempt sector into a national framework.

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[1] Anna Bernasek, *For Nonprofits, a Bigger Share of the Economy*, THE NEW YORK TIMES, (Dec. 20, 2017), https://www.nytimes.com/2014/03/09/business/for-nonprofits-a-bigger-share-of-the-economy.html.

***Contributions of the Analysis:*** *A Way to Evaluate the Tax-Exempt Sector*

This paper enriches the conceptual space in which tax-exempt and charitable organizations may be evaluated. Because tax-exempt entities generally earn a small amount of income, the authors concluded that the federal subsidy constitutes a small component of those organizations' financial structures. These enterprises provide services without primary regard to profit to the targeted populations. Indeed, enterprise profitability *per se* and donor personal benefit are specifically prohibited by the Internal Revenue Code. The absence of profit motive in combination with generally low revenue potential suggests that, overall, providing tax-exempt status for charitable organizations is the right call. Treating activity in this sector of the economy as taxable would compel administrative investment on the part of the government with little or no revenue potential. Nonetheless, the authors suggest that there is room for improvement in the preferential treatment of *charitable* tax-exempt entities. This paper outlines a process that may be utilized in order to refine the breadth of the tax expenditure and to more closely link the exemption with clear policy objectives.

The tax expenditure for charitable contributions is not the largest of the tax expenditures for individual taxpayers (that title goes to exclusion of Employer Sponsored Health Insurance[2]), but it is in the top ten. The most well-known beneficiaries of charitable contributions are 501(c)(3) charitable organizations which receive federal income tax exemption, and the respective donors of which may claim itemized tax deductions. Yet, as this paper establishes all charitable organizations are not created equal. When comparing tax-exempt entities across services provided, educational institutions and hospitals tend to benefit the most from the expenditure.[3]

*What form do these contributions take?*

A surprising finding in this paper is that corporate stock constitutes the largest component of value for this tax expenditure followed by donations of clothing.[4] But there is a marked difference between the organizations benefitted by these quite different types of donations, with the authors finding that the largest beneficiaries of the tax expenditure for noncash donations (of stock) are donor advised funds, family foundations, and education institutions.[5] Social welfare charitable organizations largely receive illiquid contributions, such as clothing, household items and furniture.[6]

With regard to revenues, this paper demonstrates that hospitals and educational institutions are, far and away, the entities most likely to generate an income stream. Yet, such educational institutions actually, with only a handful of exceptions, operate in the red. In a nutshell, their

[2] Nathan Born, U.S. Department of the Treasury, & Adam Looney, The Brookings Institution, Presentation at the National Tax Association's 111th Annual Conference on Taxation: The Tax Expenditure for Tax Exempt and Charitable Organizations (Nov. 15, 2018), *in* page 10 of https://nta.confex.com/nta/2018/mediafile/Handout/Paper1451/Born-Looney-NTA-Presentation.pdf.
[3] *Id.* at 15.
[4] Nathan Born & Adam Looney, The Tax Expenditure for Tax Exempt Organizations (Nov. 15, 2018) (unpublished manuscript) (on file with author).
[5] *Id.* at 9.
[6] *Id.* at 8-9 (for tables and a discussion by the authors).

expenses outstrip revenues. Non-profit hospitals, meanwhile, account for the largest share of total revenue for charitable organizations which poses a question: should hospitals be subject to an excise tax akin to the newly imposed[7] excise tax on private colleges and universities)? Should either of these findings inform action like that taken by Congress in the Tax Cuts and Jobs Act of 2017?

An observation here: there seems to be little or no correlation between the type of charity and categories of safety net support. In short, the two subsidy systems – direct and indirect – are not now, and have not been, complimentary. The point of the charitable itemized deduction is to identify, at the grass roots, areas of social need that are not currently being addressed by direct governmental subsidies. But, should it go further than attempting to identify gaps in the system? Should there be a link between areas of particular public need with such charitable activity? For example, the legislature could refine policy to accord especially favorable treatment to entities (and donors thereof) which address societal challenges possibly resulting from low-skill, low-wage labor; insufficient sources of child care; inadequate transportation; and housing insecurity. As alluded to in the last paragraph, this paper enriches analysis of the expenditure such that it may enable a more sophisticated, practical assessment of tax policy and revenue costs, such as in the Tax Cuts and Jobs Act of 2017 perhaps facilitating a complimentary effect.

***Applying the Analysis:*** *The Effect of the Tax Cuts and Jobs Act of 2017*

With the Tax Cuts and Jobs Act of 2017 (TCJA), Congress enacted several changes affecting tax-exempt entities, both directly and indirectly. The two variables used in this paper to estimate the federal expenditure in the tax-exempt sector—the entities' income excluded from taxation and the amount of donations deducted by individual taxpayers—could also be assessed specifically in the context of the TCJA. Such an evaluation would: update this paper's estimated cost of the expenditure for tax-exempt entities; allow for an analysis of how the TCJA specifically affects the tax-exempt sector; and enrich our ability to calculate the TCJA's overall value and cost.

<u>*Excise Taxes*</u>

One amendment to the Internal Revenue Code (IRC) aims to collect revenue from a sliver of the tax-exempt sector in the form of excise taxes (1.4%) on net investment income, thus decreasing the expenditure.[8] More precisely, it targets a small number of colleges and universities nationwide,[9] using as parameters: an enrollment of at least 500 students (with at least fifty percent located in the United States) and an asset value (at the end of the tax year) approximating $500,000

[7] *See* discussion *infra* "The Effect of the Tax Cuts and Jobs Act of 2017."
[8] 26 U.S.C. § 4968. *See also* I.R.S. Notice 2018-55, 2018-26 I.R.B. 773.
[9] The top five institutions likely affected by the new excise tax include (according to their estimated impact): Harvard, the University of Texas (system), Yale, Stanford, and Princeton. Their impact in increased revenue, though, will either increase or decrease dependent upon the financial performance of endowment portfolios. *See, e.g.*, Matthew Sussis, *Hit to leading universities from new tax may be in tens of millions of dollars*, MARKETWATCH (Jan. 16, 2018), https://www.marketwatch.com/story/hit-to-leading-universities-from-new-tax-may-be-in-tens-of-millions-of-dollars-2018-01-16.

per full-time student.[10] Such assets have previously comprised endowments providing long-term funds for sustained institutional support.

The excise implementation will tax universities in a manner comparable to that used for private foundations. Yet, this establishes that most educational institutions actually operate in the red. In light of this determination, one can reasonably ask whether an excise tax on these specific tax-exempt entities is warranted. At a minimum, the revenue collected from the few institutions potentially lessens the costs associated with preferential treatment for tax-exempt entities.

*Standard Deduction*

The TCJA 2017 doubled the standard deduction for individual taxpayers between the years of 2018 through 2025.[11] The deduction for charitable contributions was only available, of course, to those who itemized—approximately 26% of all individual taxpayers.[12] In light of the significant increase in the standard deduction, that percentage is predicted to drop to only about 10% of filers.[13]

It is possible that some percentage of former itemizers were incentivized to donate to charities to reduce their overall tax liability. Now, the taxpayers opting for the standard deduction instead may lessen or forgo their previous level of charitable support.[14] The potential decrease in individuals' donations would consequently reduce charitable deductions taken, thus reducing the overall cost estimate of this tax expenditure.[15]

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[10] 26 U.S.C. § 4968.

[11] 26 U.S. Code § 63(c)(7) (noting, also, an adjustment for inflation beginning after 31 December 2018 and scheduled sunset 31 December 2025 simultaneously suspending the individual exemption for years 2018-2015).

[12] Tax Policy Center, *T18-0002 - Impact on the Number of Itemizers of H.R.1, The Tax Cuts and Jobs Act (TCJA), By Expanded Cash Income Percentile*, URBAN INST. & BROOKINGS INST. (Jan. 11, 2018) https://www.taxpolicycenter.org/model-estimates/impact-itemized-deductions-tax-cuts-and-jobs-act-jan-2018/t18-0002-impact-number; *see also* Tax Policy Center, *T18-0003 - Impact on the Tax Benefit of Itemized Deductions of H.R.1, The Tax Cuts and Jobs Act (TCJA), By Expanded Cash Income Level*, URBAN INST. & BROOKINGS INST. (Jan. 11, 2018) https://www.taxpolicycenter.org/model-estimates/impact-itemized-deductions-tax-cuts-and-jobs-act-jan-2018/t18-0003-impact-tax.

[13] *Id.*

[14] Tax Policy Center, *Briefing Book: How did the TCJA affect incentives for charitable giving?*, URBAN INST. & BROOKINGS INST., https://www.taxpolicycenter.org/briefing-book/how-did-tcja-affect-incentives-charitable-giving (last visited Jan. 24, 2019) ("The Urban-Brookings Tax Policy Center estimates that TCJA will shrink the number of households claiming an itemized deduction for their charitable gifts from about 37 million to about 16 million in 2018[.]"); Tax Policy Center, *T18-0010 - Impact on the Tax Benefit of Charitable Deduction of H.R.1, The Tax Cuts and Jobs Act, By Expanded Cash Income Percentile*, URBAN INST. & BROOKINGS INST. (Jan. 11, 2018), https://www.taxpolicycenter.org/model-estimates/impact-itemized-deductions-tax-cuts-and-jobs-act-jan-2018/t18-0010-impact-tax; Tax Policy Center, *T18-0009 - Impact on the Tax Benefit of Charitable Deduction of H.R.1, The Tax Cuts and Jobs Act, By Expanded Cash Income Level*, URBAN INST. & BROOKINGS INST. (Jan. 11, 2018), https://www.taxpolicycenter.org/model-estimates/impact-itemized-deductions-tax-cuts-and-jobs-act-jan-2018/t18-0009-impact-tax.

[15] *Briefing Book supra* n.14 ("The Urban-Brookings Tax Policy Center estimates that TCJA will…reduce the federal income tax subsidy for charitable giving by one-third, from about $63 billion to roughly $42 billion."); *see also* Howard Gleckman, *21 Million Taxpayers Will Stop Taking the Charitable Deduction Under The TCJA*, Tax Policy Center: TaxVox, URBAN INSTITUTE & BROOKINGS INSTITUTION (Jan. 8, 2018), https://www.taxpolicycenter.org/taxvox/21-million-taxpayers-will-stop-taking-charitable-deduction-under-tcja.

It remains to be seen whether the drop-off actually occurs, but should there be changes, the nuanced analysis will be assisted by the approach developed in this paper. With it, a clearer picture will emerge of the extent to which charities are impacted by the TCJA and which types of tax-exempt entities are most vulnerable to the change.

*Estate & Gift Taxes*

Furthermore, the TCJA amended Subtitle B of the IRC to double the unified tax credit for estate[16] and gift[17] tax liability until 2025. Specifically, the amendment raised the exempt amounts for estate and gift tax liability per taxpayer from $5,000,000 to $11,400,000 (as adjusted for 2019 inflation).[18] For married couples, the exempt amount is now to $22,800,000.

An important deduction for estate planning purposes has been that taken for charitable contributions. With the doubled exemption, the number of individuals with such estate tax liabilities is expected to decrease from, approximately, 5,500 to 1,700.[19] Nearly 3,800 individuals who might have otherwise donated to a tax-exempt entity to take advantage of the deduction may now choose not to do so. The lack of a donation incentive may well decrease the Subtitle B federal tax-expenditure for tax-exempt entities.

*State and Local Tax* **(***SALT) Deduction*

The decreasing indirect federal expenditure on tax-exempt entities may simply shift the revenue cost to states. The changes, however, may not be offsetting particularly in light of the cap imposed by the TCJA on the amount deductible by itemizers for state and local taxes (SALT) borne. As amended, an individual's aggregate deduction for state and local income, property, and sales taxes is limited to $10,000 until 2025.

High-tax states tend to have more comprehensive social welfare programs relying on revenue collected from high-income residents through property and income tax to afford them.[20] The federal government historically permitted an unlimited SALT deduction in order to facilitate state (and local) revenue-raising capacity particularly with regard to high-income – i.e., itemizing – residents; the deduction protected this group from being taxed twice on the same amounts for both federal and state purposes.[21] As a result, state and local governments could adjust rates without

[16] 26 U.S.C. § 2010(c)(3)(C).
[17] 26 U.S.C. § 2505(a)(1); 26 U.S.C. § 2010(c)(3)(C).
[18] Rev. Proc. 2018-57, 2018-49 I.R.B. 41.
[19] Howard Gleckman, *Only 1,700 Estates Would Owe Estate Tax in 2018 Under the TCJA*, Tax Policy Center: TaxVox, URBAN INST. & BROOKINGS INST. (Dec. 6, 2017), https://www.taxpolicycenter.org/taxvox/only-1700-estates-would-owe-estate-tax-2018-under-tcja; Tax Policy Center, *T17-0308 - Estate Tax Returns and Liability Under Current Law and the House and Senate Versions of the Tax Cuts and Jobs Act, 2018-2027*, URBAN INST. & BROOKINGS INST. (Dec. 6, 2017), https://www.taxpolicycenter.org/model-estimates/estate-tax-and-tax-cuts-and-jobs-act-dec-2017/t17-0308-estate-tax-returns-and.
[20] High-state tax and local jurisdictions most adversely affected by SALT limitation: California, New York, New Jersey, Connecticut, Illinois, Massachusetts, and the District of Columbia (all blue states).
[21] While this may seem like an expensive expenditure, collectively, individuals in high-tax states pay comparatively more in federal taxes than those in low-tax states. Even though the liability that those individuals faced was reduced with the SALT deduction, their ultimate payment still outweighed the federal assistance their communities received in return. *See, e.g.*, Scott Ahroni, Biagio Pilato and Benjamin Silliman, *Congress and the SALT Deduction: Past, Present, and Future*, CPA JOURNAL (Jan. 2018), https://www.cpajournal.com/2018/01/22/congress-salt-deduction/.

undue concern for taxpayer exit. The amendment may promote taxpayer-exit for those high earners as they flee to lower-tax states pulling their potential revenue from state and local tax pools.[22] In any event, at least two possible outcomes immediately surface.

First, state and local spending may become less comprehensive. State and local governments may need to adjust their own direct expenditures to meet needs that can no longer be financially borne on either the federal or state level.

Second, to prevent taxpayer exit, higher-tax sub-national governments may lock-in (despite inflation) or even lessen their rates to remain attractive. Government programs may become over-burdened without adequate resources such that charitable organizations otherwise poised to step up to ease the pressure may themselves be faced with increasing financial distress.

Either way, money saved through a lessened tax expenditure on tax-exempt entities may indirectly increase the cost to states. Again, the approach taken in this paper may enable a more nuanced examination of the relationship between the TCJA and those organizations.

***Completing the Analysis:*** *Additional Considerations for the Authors' Model*

Future research modeling the approach developed here may be further enriched in two ways. First, mimicking federal tax treatment, charitable organizations have also enjoyed some measure of preferential treatment for state and local tax purposes. The form of those measures, the economic impact thereof on both the entity and the state or local economy, and changes that may be underway on those levels may all be questions of interest yielding insights important on all governmental levels. Second, the emergence of entrepreneurial initiatives that engage in a mix of profit as well as at least marginally non-profit activity adds yet another layer of complexity.

*Charitable Organizations in the Federalist System*

The estimation of the tax expenditure's revenue cost may be further developed by factoring in state and local tax treatment of charitable organizations. Relatively little effort, thus far, has been put into tracking and quantifying such treatment. Nevertheless, these sub-national governments should be recognized as participants in the "indirect expenditure" game for two reasons.

First, most states align their definition of a "tax-exempt" entity with that of the federal government. So legislation on this expenditure actually has far reaching effects: the tax-exempt organization is neither liable for federal income taxes nor state taxes, such as income and sales taxes generally and certain property-related taxes. Sub-national units have, however, limited the application of tax-exempt status by not automatically extending it to special taxes and assessments, fees, and user charges.

[22] States likely least affected by SALT limitation: Texas and Florida (red states with no income tax).

Second, a number of local governments are beginning to ask tax-exempt organizations to make voluntary make payments in lieu of taxes (PILOTS) to offset lost property tax revenue.[23] These agreements particularly target affluent organizations which would have considerable liability if were subject to taxation.[24] Paralleling the authors' finding of high federal income tax expenditures for hospitals and educational institutions,[25] these same organizations benefit the most from local property tax exemptions.[26] Thus, a local government's adoption of PILOTS, or lack thereof, may influence the expenditure's ultimate revenue cost.

*And Perhaps Tongue-in-Cheek? Popular Culture Headwinds*

Online crowdfunding platforms, such as "GoFundMe"[27] and "KickStarter"[28] allow individuals to both advertise their own fundraisers and directly contribute to attractive causes. These easy-to-access sites may affect the operation of, and popular support for, established charities by redirecting contributions (and therefore revenue) which would otherwise flow to more traditional organizations.

***Conclusion***

I end as I began. The novel approach taken in this very interesting paper has deepened my understanding of the effect of tax expenditures on the financial structure and outlook of tax-exempt entities. The authors' approach significantly contributes to an understanding of how this tax expenditure has worked and enables a more nuanced examination of these issues going forward.

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[23] Daphne A. Kenyon & Adam H. Langley, *Nonprofit PILOTs (Payments in Lieu of Taxes)*, LINCOLN INSTITUTE OF LAND POLICY, https://www.lincolninst.edu/sites/default/files/pubfiles/nonprofit-pilots-policy-brief.pdf (last visited Jan. 24, 2019).

[24] Daphne A. Kenyon & Adam H. Langley, THE PROPERTY TAX EXEMPTION FOR NONPROFITS AND REVENUE IMPLICATIONS FOR CITIES 2 (Lincoln Institute of Land Policy, 2011), https://www.urban.org/sites/default/files/publication/26756/412460-The-Property-Tax-Exemption-for-Nonprofits-and-Revenue-Implications-for-Cities.PDF ("Sherlock and Gravelle (2009) estimated that in fiscal year 2009, property tax revenues forgone due to the charitable exemption were between $17 and $32 billion nationally, or roughly 4 to 8 percent of total property taxes.").

[25] Born & Looney, *supra* n.2, at 15 ("Tax Expenditure for tax exempt organization benefits hospitals ($15B) and education institutions ($12B)").

[26] Kenyon & Langley, *supra* n.26, at 3 ("Among nonprofits that do own property, average tax savings for hospitals ($3.7 million) and higher education institutions ($2.9 million) are much greater than average savings for nonprofits that provide human services ($107,156), community improvement ($88,327), housing and shelter ($76,111), and all other types of organizations.").

[27] GoFundMe is a for-profit crowdfunding platform that allows people to raise money for events ranging from life events such as celebrations and graduations to challenging circumstances like accidents and illnesses. The platform may be used to fundraise for both individual and entity initiatives. *See* How GoFundMe Works, GOFUNDME, https://www.gofundme.com/how-it-works (last visited Jan 31, 2019).

[28] The funding goal for Kickstarter is the amount of money that a creator needs to complete their project. Nonprofits may launch projects on Kickstarter but projects can't promise to raise funds to donate to a charity or cause. *See* About, KICKSTARTER, https://www.kickstarter.com/about?ref=global-footer (last visited Jan 31, 2019).