

# **CHARITY TO THE RICH - SHOULD SOME CHARITABLE DEDUCTIONS BE DISALLOWED?**

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## **Abstract**

This paper discusses a proposal by a former cabinet member to limit the deductibility of charitable contributions. The proposal suggests that charitable contributions to “rich” organizations be disallowed. The paper reviews recent literature on the effect of changing tax rates on charitable giving, and motivation for giving by upper-income taxpayers. Academic literature shows little affect on giving by the lower- or upper-income taxpayers. However, there is no consensus on the effect of tax rate manipulation on giving by the middle class.

## **INTRODUCTION**

One of the current endeavors in Congress is to identify new revenue sources to fund Congressional initiatives, such as comprehensive health care. The President has asked Congress to fund new initiatives using cuts in spending or revenue enhancements. Revenue enhancements can come in the form of new tax rates or increasing the tax base.

The tax base can be increased by eliminating or limiting deductions, or by taxing previously exempt income. Itemized deductions are often a target of revenue enhancement. A modification that has been proposed is a limitation of the deduction for charitable donations. The limitation would be structured to only affect upper-income taxpayers, which is not an approach we

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advocate. Another proposal questioned the deduction of a charitable contribution to “rich” charities (Frank 2007). This paper discusses the possible effects of these proposals on charitable organizations.

### **LIMITING ITEMIZED DEDUCTIONS**

Past legislation eliminated personal interest deductions for cars and credit cards, mortgage interest now has several limitations (Internal Revenue Code Sec.163), medical deductions are limited to those that exceed 7.5 % of adjusted gross income (IRC Sec.213), and there is an overall limitation on itemized deductions (IRC Sec.68) for upper-income taxpayers. While charitable donations already have several limitations (IRC Sec.170), there has been belief that charitable giving that may not always go to entities that are in need. Gifts to “rich” institutions such as art museums, colleges and universities, and symphonies, may not fit the common conception of charitable giving. Charity is often thought of as giving to those in need.

One group that is exploring new revenue sources for the Treasury is the Senate Finance Committee. One of its current projects involves examining the rising costs of higher education and the growth of college endowments. The Committee has contacted the 136 wealthy (judged by endowments) colleges and universities to obtain detailed information on how they raise tuition, provide financial aid and manage, and spend their endowment.

The Committee is also interested in the endowment-related bonuses paid to college presidents and endowment managers. It appears that a secondary reason for this probe is to determine whether the endowment funds are too large and if colleges and universities are really helping the disadvantaged. It is worth noting that five universities had endowments greater than \$10 billion at the end of 2008, even with an approximate decline of 23% in the last six months of the year. These figures come from a survey by the National Association of College and University Business Officers.

If wealthy entities continue to collect donations, should donors be allowed to deduct those donations as if they went to organizations that are truly in need or are in the “business” of helping the needy? The next section distinguishes between the two most common types of non-profit organizations.

### **NON-PROFIT ORGANIZATIONS**

Non-profit organizations (NPOs) generally receive a significant portion of their funding or operating budget from contributions. Their operating goal is to provide, without a profit motive, goods or services to the citizenry. NPOs represent a large and varied group of organizations including hospitals, colleges and universities, libraries, museums, religious organizations and trade associations. The trade off for providing such goods and services is that NPOs receive tax exemption under one of the more than 25 classifications of IRC Sec. 501.

The most common NPOs are community chests, funds and foundations that are exempt from taxation under IRC Sec. 501(c)(3). Private foundations and public charities are the two major types of charitable organizations included within the Code’s definition of exempt organizations, although there are some very large community foundations. The difference between foundations and public charities is that private foundations receive support from a small number of individuals or corporations and exist to provide grants to public charities. One well established private foundation is the Bill & Melinda Gates Foundation with an endowment totaling \$27.5 billion as of April 1, 2009 (Anonymous, 2009).

On the other hand, public charities are better known since they are funded, operated, and monitored by the public at large rather than by a limited number of donors. Common public charities include Goodwill Industries of America and American Cancer Society.

IRC Sec.170 allows charitable contributions (gifts) to be deductible, with some limitations, if the contribution is made to:

- A State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.
- A domestic corporation, trust, or community chest, fund, or foundation -- organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, and that is not disqualified for tax exemption under Sec. 501(c)(3)
- A post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization -- organized in the United States or any of its possessions, and
- In the case of a contribution or gift by an individual, a domestic fraternal society, order, or association, operating under the lodge system, but only if such contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals
- A cemetery company owned and operated exclusively for the benefit of its members, or any corporation chartered solely for burial purposes as a cemetery corporation

There are an estimated 837,000 charitable non-profits in the United States, excluding foundations and religious organizations (Schwadron, 2007). NPOs, except most religious organizations, file annual reports with the IRS using Form 990.

Gifts to charities play an important role in the economy and they are the life blood of many charitable institutions. Charitable

donations totaled an estimated \$307.65 billion in 2008 according to the new Giving USA 2009 report. The report confirmed a two percent drop from 2007 giving, which totaled a record \$314.07 billion. It was the first decline in charitable giving that Giving USA has reported since 1987, and only the second since Giving USA began publishing annual reports in 1956. Charitable foundations saw the biggest decrease in giving, with a 19.2 percent decline, but religious congregations and other religious organizations received an estimated \$106.89 billion in 2008, a 5.5 percent increase over the previous year (Muth, 2009).

### **RICH CHARITIES**

Some organizations that solicit funds have sufficient assets that demonstrate that they have no current need for additional funds. As noted previously, the Senate Finance Committee requested information from educational institutions. Seventy-five colleges and universities registered endowments of \$1 billion or more at the end of fiscal year 2008 (Anonymous, 2008).

Table 1 shows 10 universities with the largest endowments. Scaling for size by showing endowment per student would be useful, but no recent reliable figures are available. The figures in the 2009 column were estimated using the National Association of College and University Business Officers Endowment Report estimated 23 percent decline in endowment value.

**Table 1**  
**Top 10 University Endowments**

<b>Institution</b>	<b>Endowment (2005) billion</b>	<b>Endowment (2006) billion</b>	<b>Endowment (2007) billion</b>	<b>Endowment (2008) billion</b>	<b>Estimated Endowment (2009) billion</b>
<b>Harvard</b>	\$ 25.473	\$ 28.916	\$ 34.635	\$ 36.556	\$28.15
<b>Yale</b>	\$ 15.224	\$ 18.031	\$ 22.530	\$ 22.870	\$17.61
<b>Stanford</b>	\$ 12.205	\$ 14.085	\$ 17.165	\$ 17.200	\$13.24
<b>Princeton</b>	\$ 11.207	\$ 13.045	\$ 15.787	\$ 16.349	\$12.59
<b>Texas</b>	\$ 11.610	\$ 13.235	\$ 15.614	\$ 16.111	\$12.41
<b>Massachusetts</b>	\$ 6.712	\$ 8.368	\$ 9.980	\$ 10.069	\$7.75
<b>Michigan</b>	\$ 4.931	\$ 5.652	\$ 7.090	\$ 7.572	\$5.83
<b>Northwestern</b>	\$ 4.215	\$ 5.141	\$ 6.503	\$ 7.244	\$5.58
<b>Columbia</b>	\$ 5.191	\$ 5.938	\$ 7.150	\$ 7.147	\$5.50
<b>Texas A&amp;M</b>	\$ 4.964	\$ 5.643	\$ 6.590	\$ 6.659	\$5.13
Anonymous, 2008					

*Forbes* annually publishes a list of the 200 largest charities by net assets. The table below shows the top 10 public charities ranked by net assets. *Forbes* derived the information from the IRS Form 990, annual report or statement from the individual charity, and [www.guidestar.org](http://www.guidestar.org).

The 2008 information is available in 2009. Although not relevant to the discussion of deductions for donations to rich charities, the other columns in Table 2 provide interesting and useful information for donors. In Table 2 Private Support means gifts to the charity.

Fundraising Efficiency is a measure of the remaining private support after deducting fundraising expenses. Goodwill Industries and Shriners Hospitals for Children were the most efficient charities retaining 96% and 95% respectively of gifts after fundraising expenses. Charitable Commitment is a measure of money spent on charitable services (the mission of the entity) as a percentage of total expenses.

The Mayo Clinic spent the most money (97%) from its contributions on what the IRS 990 calls Program Services. Donor Dependency is a measure of how much the entity needs private support and is calculated independent of the other two categories. The higher the number, the more the entity needs the public donations.

A negative number, on the other hand, shows that the entity's surplus was larger than the total gifts. Of the top 10 on this list, both the American Red Cross and Goodwill Industries are the most dependent on private support while it appears that the Children's Hospital could survive the longest by spending its accumulated net assets.

**Table 2**  
**Top 10 Public Charities by Net Assets**  
**For 2008**

<b>Name</b>	<b>Net Asset (\$mil)</b>	<b>Private Support (\$mil)</b>	<b>Fundraising Efficiency (%)</b>	<b>Charitable Commitment (%)</b>	<b>Donor Dependency (%)</b>
<b>Salvation Army</b>	10,853	1,998	92	82	39
<b>Shriners Hospitals for Children</b>	9,716	243	95	92	26
<b>Nature Conservancy</b>	4,715	486	87	80	4
<b>Mayo Clinic</b>	4,309	367	91	97	-69
<b>Memorial Sloan-Kettering Cancer Center</b>	4,045	239	86	93	-60
<b>American National Red Cross</b>	3,224	643	78	89	94
<b>Metropolitan Museum of Art</b>	3,205	126	93	90	-298
<b>Children's Hospital of Philadelphia</b>	2,957	65	85	85	-321
<b>Goodwill Industries International</b>	2,948	490	96	88	68
<b>Cleveland Clinic Foundation</b>	2,803	152	92	89	-308
<i>Forbes</i> <b>Barrett (2009)</b>					

If Congress wanted to eliminate the deduction of contributions to rich charities, how would one determine if a charity is rich? The definition of “rich” would need to entail more than simply looking at the amount of net assets. Some charities, e.g., the American Red Cross, receive millions of dollars in

donations each year, but they also spend millions of dollars. Some measure of donor dependency seems like a much better classification scheme. The Better Business Bureau has a *Charity Seal Program* with Standards for Charitable Accountability.

Organizations that comply with these accountability standards must provide documentation that demonstrates that the entity meets basic standards:

- In how they govern their organization,
- In the ways they spend their money,
- In the truthfulness of their representations, and
- In their willingness to disclose basic information to the public.

One condition of the second standard is that the entity will:

“Avoid accumulating funds that could be used for current program activities. To meet this standard, the charity's unrestricted net assets available for use should not be more than three times the size of the past year's expenses or three times the size of the current year's budget, whichever is higher.”

We don't presume to have the answer to the question of how to determine if a charity is rich, but there are certainly guidelines and public information (IRS 990) available to make an intelligent classification scheme.

## **CURRENT TAX TREATMENT OF CHARITABLE CONTRIBUTIONS**

As noted earlier, individual donor groups are the main funding source for charitable organizations hence the tax treatment of their contributions is our primary focus. Individual taxpayers can receive a charitable contribution deduction by making a gift to a Sec. 501(c)(3) organization (and certain other exempt organizations). As defined earlier by IRC Sec. 170, this generally means “A domestic corporation, trust, or community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster

national or international amateur sports competition.” This definition includes a wide range of organizations from the Boys Scouts to religious organizations to veterans’ organizations.

Deductible amounts include cash, property and out-of-pocket expenses incurred to perform volunteer work. No donation is allowed for the value of services provided to an organization. The full value of these donations is generally deductible on Form 1040 Schedule A, subject to certain limitations based on the individual’s adjusted gross income and whether the property is ordinary income or capital gain property. Excess contributions are carried forward for five years. Other contributions such as gifts to political organizations, to unrelated individuals or relatives, and gifts with the expectation of deriving value in exchange (*quid pro quo*) are not deductible.

#### **DISALLOWED CHARITABLE CONTRIBUTIONS AND IMPACT ON NON-PROFIT ORGANIZATIONS**

NPOs and the federal government have agreed that NPOs could avoid taxation in exchange for providing certain goods and services to society. This agreement is codified in IRC Sec. 501. These goods and services might be forgone or provided by government if NPOs did not exist. Allowing NPOs to operate in the public sector avoids the government increasing taxes to provide services that Congress deems necessary and appropriate. The individual taxpayer is allowed to help fund the organization of his/her choice.

#### **Low-Income Taxpayers**

We believe that a change to limit the deductibility of charitable contributions of low-income taxpayers would have little or no impact on most NPOs. According to the 2000 Social Capital Community Benchmark Survey, households with income below adjusted gross income (henceforth, income) \$20,000, already contribute the highest percentage of their income (4.6%) to charity (Brooks, 2008) than any other income group.

However, the author is careful to point out that this percentage holds true only for the working poor, not for all households with income less than \$20,000. This finding supports the results of a past study (Schervish and Havens, 1995) that demonstrated two different results depending on the population used to calculate the statistics. Using all households with income below \$20,000 these households give 1.4% to 2.8% depending on the exact income level below \$20,000. The higher percentage of giving is the result of using only those families with income below \$20,000 who actually make charitable contributions.

The working poor, as they are known, rarely benefit from the tax deductibility of charitable contributions. In 2009, the standard deduction for couples filing jointly was \$11,400. Households with income of \$20,000 would have to qualify for a \$124,000 mortgage with 7% simple interest (which overstates the amount), property taxes estimated at 1.2% of the mortgage to come close to the standard deduction. Without mortgage interest and property taxes, very few taxpayers can itemize their deductions.

IRS sample data for 2006 from the *Statistics of Income Bulletin* (the most recent data available) shows that itemized deductions do not exceed the standard deduction amount until adjusted gross income exceeds \$50,000. There is obviously an incentive other than a tax deduction for these taxpayers with family incomes of less than \$20,000 to give to charitable organizations.

Levels of giving are positively associated with income, wealth, religious participation, education, and several other characteristics. (Havens, O'Herlihy & Schervish, 2006) However, an earlier paper (Schervish and Havens, 1995) discovered that "Lower income [contributing] households give a larger percentage of their income to religion than do higher income households, and both [groups] give larger percentages than do middle income households."

Given the fact that lower income families would rarely derive a tax benefit from charitable deductions, it is reasonable to assume their charitable giving would remain unchanged. This

finding is supported by the most recent Giving USA report that found a 5.5 percent increase in giving to religious organizations despite the overall 19.2 percent decrease in total giving. This is also consistent with a paper by Bradley, Holden, and McClelland (2000) that found that contributions to religious organizations are much less responsive to tax incentives than contributions to social welfare organizations.

### **Upper-Income Taxpayers**

Based on current research, we don't believe that the tax deductibility of charity contributions is the primary motivation for very wealthy households. In a 2006 study (Schervish and Szántó) on wealth and philanthropy, a survey provides an insight into the charitable giving of the very wealthy. The results of this survey are based on responses from 96 individuals with assets of ten million dollars or more. These donors represent .4% of the total population and yet donate 20% of all charitable dollars.

The responders were allowed to give two answers to each of the following questions, therefore, the percentages sum to more than 100%. In answer to the question "What influences have most shaped the focus of your charitable giving?" almost two thirds (64%) of the responses indicated "Desire to make an impact on society." The second most powerful influence (30%) is "Personal experience with the needy." The third ranked influence (27%) is "Gratitude for opportunities received."

In answer to the question "Where do you personally focus your philanthropic giving today?" participants were allowed to indicate several areas. The top three choices were education (42%), human services and youth programs (39%), and health (17%). The biggest perceived obstacle to charitable giving was inefficient or ineffective management of the charitable organization.

What then is the impact on NPOs if these very wealthy households lose a deduction for charitable giving? Since "tax benefits" would be lumped into the "Other" category that only

accounted for 1% of the influence on giving, we would again predict no change in giving patterns.

### **Middle-Income Taxpayers**

That leaves the middle-income taxpayers. Numerous studies over the last two decades have attempted to qualify the effect of tax law changes on the charitable giving of middle-income taxpayers. The academic methodology is to determine the elasticity of charitable contributions with respect to the cost or price of giving \$1. That is, what is the net after-tax cost of giving, and how is giving affected by a change in tax rates.

Choe and Jeong (1993) state that research on contributions by low- and middle-income groups show mixed results with contradictory views held by academics. They feel the mixed results stem from statistical bias due to the large number of “zero contributions” and the progressive nature of the tax system that could allow a taxpayer to lower their tax rate by a large deductible contribution.

Broman (1989) states that “...the price of giving appears to have little lasting impact on the contributions behavior, at least not on the behavior of middle-income itemizers such as those who dominated this study’s sample.” Dunbar and Phillips (1997) state “Although this body of research provides mixed evidence concerning the price elasticity of charitable giving, the consensus is that the charitable contribution deduction is an efficient incentive for itemizers.” Their research concluded that “... the elimination of the limitation on the non-itemizer [charitable] deduction in 1986 stimulated additional giving and prompted 1985 non-givers to become givers in 1986.”

Unlike the very wealthy and the working poor, there is a scarcity of anecdotal evidence of their behavior. The most honest conclusion that we can draw after reviewing numerous academic studies is that there is no consensus about the size of the effect, if any, of tax rates on the giving of middle-income taxpayers.

**CONCLUSION**

The U.S. Congress is always exploring new ways to generate revenue for the Treasury. One potential revenue stream is the income generated by reducing the deductibility of charitable contributions made to organizations that already have large endowments. Clearly, the characterization of a charitable organization as rich cannot be determined based solely on its contributions received.

We understand the need for the government to explore alternative approaches in order to fund Congressional initiatives such as health care. However, we discourage Congress from adopting any proposal that might reduce the tax deductibility of charitable contributions without fully analyzing the impact of any such tax change. Although we hypothesize that the very wealthy (assets of \$10 million or more) and the working poor (adjusted gross income of \$20,000 or less) will not change their behavior, there is a vast body of taxpayers in between. Adjusting the deductibility of charitable contributions based on the wealth of an organization suggest class warfare, which is not a position we advocate.

We believe that the cost to society of any change in the current treatment of charitable contributions will be greater than any derived benefit. Although, it might be tempting to reduce the deductibility of donations to rich charitable organizations, we suggest that (1) no change is made to the tax laws until the determination of how to classify a charity as rich is settled and (2) the behavior of taxpayers in between the working poor and the very wealthy is understood.

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