DESCRIPTION OF PRESENT LAW AND CERTAIN PROPOSALS RELATING TO CHARITABLE GIVING AND INDIVIDUAL DEVELOPMENT ACCOUNTS

Scheduled for a Joint Hearing
before the
SELECT REVENUE MEASURES AND
HUMAN RESOURCES SUBCOMMITTEES
of the
HOUSE COMMITTEE ON WAYS AND MEANS
on June 14, 2001

Prepared by
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INTRODUCTION

The Subcommittees on Select Revenue Measures and on Human Resources of the House Committee on Ways and Means have scheduled a joint hearing on issues relating to charitable giving and individual development accounts for June 14, 2001.

This document,[1] prepared by the staff of the Joint Committee on Taxation, contains a description of present-law rules and proposals contained in H.R.7, the "Community Solutions Act of 2001,"[2] relating to Federal tax incentives for charitable giving and individual development accounts.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Present Law and Certain Proposals Relating to Charitable Giving and Individual Development Accounts* (JCX-55-01), June 13, 2001.

[2] H.R.7 was introduced on March 29, 2001, by Representative Watts and others.

I. INCENTIVES FOR CHARITABLE GIVING

A. Provide a Charitable Deduction for Nonitemizers

Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to a charity described in section 501(c)(3) or a Federal, State, or local governmental entity. The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[3]

A taxpayer who does not itemize deductions (i.e., who takes the standard deduction) may not take a separate deduction for charitable contributions.[4]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[5] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[6]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations

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[3] Secs. 170(b) and (e).

[4] Sec. 170(a). The Economic Recovery Tax Act of 1981 adopted a temporary provision that permitted individual taxpayers who did not itemize income tax deductions to claim a deduction from gross income for a specified percentage of their charitable contributions. The maximum deduction was $25 for 1982 and 1983, $75 for 1984, $150 for 1985, and $300 for 1986. The nonitemizer deduction terminated after 1986.

[5] Sec. 170(f)(8).

[6] Sec. 6115.

may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback).[7] To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.[8]

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limit may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation.[9] The threshold amount for 2001 is $132,950 ($66,475 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by 3 percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. The effect of this reduction is to limit partially a taxpayer's charitable contributions deduction.

Description of Proposal

Section 101 of H.R.7 would allow taxpayers who do not itemize their deductions to deduct their charitable contributions up to the amount of the standard deduction, in addition to their standard deduction. Amounts that would otherwise be deductible under section 170 could be deducted from adjusted gross income, in the same manner as the standard deduction and the deduction for personal exemptions under present law. The percentage limitations, substantiation requirements, carryforward, and other present-law rules would apply to nonitemizer charitable contributions. The nonitemizer deduction would be allowed for purposes of calculating alternative minimum taxable income.

Effective date.--The deduction would apply for taxable years beginning after the date of enactment.

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[7] Sec. 170(b)(1)(A).

[8] Sec. 170(b)(1)(B), (C), and (D).

[9] Sec. 68.

B. Permit Tax-Free Distributions from IRAs for Charitable Purposes

Present Law

Under present law, individuals may make deductible and nondeductible contributions to a traditional individual retirement arrangement ("IRA"). Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals may also make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless an exception applies.

If an amount withdrawn from a traditional IRA or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply and the charitable contribution is subject to the normally applicable limitations on such contributions, e.g., the percentage limitations and the overall limit on itemized deductions. Thus, for example, under present law, a taxpayer subject to the phaseout on itemized deductions would not be able to deduct the full amount of an IRA distribution given to charity.

Description of Proposal

Section 102 of H.R.7 would provide an exclusion from gross income for otherwise taxable IRA withdrawals from a traditional or a Roth IRA for qualified charitable distributions. A qualified charitable distribution would be defined as any distribution from an IRA that is made on or after the date the IRA owner attains age 59-1/2, and that is made directly (1) to a charitable organization to which deductible contributions can be made; (2) to a charitable remainder annuity trust or charitable remainder unitrust; (3) to a pooled income fund (as defined in sec. 642(c)(5)); or (4) for the issuance of a charitable gift annuity. The exclusion would apply with respect to distributions described in (2), (3), or (4) only if no person holds an income interest in the trust, fund, or annuity attributable to such distributions other than the IRA owner, his or her spouse, or a charitable organization.

In determining the amount includible in gross income by reason of a payment from a charitable remainder annuity trust or charitable remainder unitrust to which a qualified charitable distribution from an IRA was made, the taxpayer would be required to treat as ordinary income (as described in sec. 664(b)(1)) the portion of the distribution from the IRA to the trust which would have been includible in income but for the proposal. Similarly, in determining the amount includible in gross income by reason of a payment from a charitable gift annuity purchased with a qualified charitable distribution from an IRA, the taxpayer would not be permitted to treat the portion of the distribution from the IRA used to purchase the annuity as an investment in the annuity contract.

The amount otherwise allowable as a deduction to the individual for the year as charitable contributions would be reduced by the amount of qualified charitable distributions that would otherwise be includible in income.

Effective date.--The bill would be effective for taxable years beginning after the date of enactment.

C. Establish Enhanced Deduction for Charitable Contributions of Food Inventory

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the deduction is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.[10]

Under present law, a taxpayer's deduction for charitable contributions of food inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory. However, C corporations may claim a deduction in excess of basis for certain charitable contributions.[11] This augmented deduction is equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value minus basis) or (2) two times basis. To be eligible for an enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of ongoing disputes between taxpayers and the IRS. In one case, the Tax Court held that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted.[12]

Description of Proposal

Section 103 of H.R.7 would amend the present-law charitable contribution deduction rules of section 170 to (1) expand the class of taxpayers eligible to claim an augmented deduction for charitable contributions of food inventory, (2) change the calculation of the deductible amount and cap the maximum benefit at fair market value, and (3) modify and clarify the determination of fair market value for such contributions.

Under the bill, any taxpayer, rather than only a C corporation, engaged in a trade or business would be eligible to claim an enhanced deduction for donations of food inventory under section 170(e). Moreover, the calculation of the enhanced deduction under the bill differs from present law. The enhanced deduction for food inventory would equal fair market value less the amount (if any) by which the amount of the contribution exceeds twice the basis of the donated food. For example, if donated food had a value of $40 and a basis of $15, the amount of the deduction would be reduced from fair market value by $10 because the amount of the

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[10] Sec. 170(e)(1).

[11] Sec. 170(e)(3).

[12] *Lucky Stores Inc. v. Commissioner,* 105 T.C. 420 (1995).

contribution ($40) exceeds twice basis ($15 X 2) by $10, resulting in a deduction of $30. However, if basis were $20 the deduction would equal $40 because the amount of the contribution ($40) would not exceed twice basis ($20 X 2) so there would not be a reduction from fair market value. For purposes of the enhanced deduction, taxpayers who use the cash method of accounting have a deemed basis of 50 percent of the fair market value of the contribution.

In addition, the bill would provide that the fair market value of donated food that cannot or will not be sold solely due to internal standards of the taxpayer, lack of market, or similar circumstances, would be determined without regard to such factors and, if applicable, by taking into account the price at which the same or similar food items are sold by the taxpayer at the time of the contribution or in the recent past.

Effective date.--The bill would be effective for taxable years beginning after December 31, 2001.

II. INDIVIDUAL DEVELOPMENT ACCOUNTS

Present Law

Individual development accounts were first authorized by the Personal Work and Responsibility Act of 1996. In 1998, the Assets for Independence Act established a five-year $125 million demonstration program to permit certain eligible individuals to open and make contributions to an individual development account. Individual development account contributions do not receive a tax preference but are matched by contributions from a state program, a participating nonprofit organization, or other "qualified entity." The IRS has ruled that matching contributions (and earnings thereon) by a qualified entity are a gift and not taxable to the account owner.[13] The qualified entity chooses a matching rate, which must be between 50 and 400 percent. Individual development account withdrawals can be made for certain higher education expenses, a first home purchase, or small business capitalization expenses. Matching contributions typically are held separately and must be paid directly to a mortgage provider, university, or business capitalization account at a financial institution. The Department of Health and Human Services administers the individual development account program.

Description of Proposal

H.R.7 would provide for a tax credit for an eligible entity (i.e., qualified financial institutions or their contractual affiliates) that has an individual development account program in a taxable year. The tax credit would be equal to the amount of matching contributions made by the eligible entity under the program (up to $500 per taxable year) plus $100 for each individual development account opened during the taxable year under the program plus $30 for each individual development account maintained during the taxable year under the program. The amount of the credit would be adjusted for inflation after 2002. No deduction or other credit would be available with respect to the amount of matching funds taken into account in determining the credit.

Nonstudent U.S. citizens or legal residents between the ages of 18 and 60 (inclusive) that meet certain income requirements would be eligible to open and contribute to an individual development account. An individual would be required to certify that he or she owns no other individual development account (except in the case of a rollover) and present documentation of income eligibility. The income limit would be adjusted gross income of $20,000 for single filers, $40,000 for joint-filers, and $25,000 for head-of-household filers. Eligibility in a taxable year would be based on the previous year's adjusted gross income. The income limits would be adjusted for inflation after 2002.

Under the bill, an individual development account must: (1) be solely owned by the eligible individual for whom the account was established, (2) consist only of cash contributions, (3) be held by a qualified financial institution (i.e., any person authorized to be a trustee of any individual retirement account under section 408(a)(2)), and (4) not commingle account assets with other property (except in a common trust fund or common investment fund). These

[13] Rev. Rul. 99-44, 1999-2 C.B. 549.

requirements must be reflected in the written governing instrument creating the account. An individual development account must be established for an eligible individual as part of a qualified individual development account program, which could be established by any qualified financial institution, qualified nonprofit organization, or Indian tribe. The entity establishing the program would be required to establish as part of the program a separate parallel account for all matching funds and earnings thereon. Parallel accounts would be dedicated to an individual development account and would be exempt from tax under the bill.

The bill would permit individuals to withdraw amounts from an individual development account for qualified expenses of the account owner, owner's spouse, or dependents as well as nonqualified expenses subject to certain restrictions. Qualified expenses include qualified: (1) higher education expenses (as generally provided by section 72(t)(7)), (2) first-time homebuyer costs (as generally provided by section 72(t)(8)), (3) business capitalization or expansion costs (expenditures made pursuant to a business plan that has been approved by the financial institution, nonprofit, or Indian tribe), (4) rollovers of the balance of the account (including the parallel account) to another individual development account for the benefit of the same owner, and (5) final distributions in the case of a deceased account owner. Withdrawals for qualified expenses must be paid directly to the unrelated third party to whom the amount is due, except in the case of expenses under a qualified business plan, rollover, or final distribution. Such withdrawals would not be permitted until the account owner completes a financial education course offered by a qualified financial institution, qualified nonprofit organization, Indian tribe or governmental entity. The Secretary of the Treasury (the "Secretary") would be required to establish minimum standards for such courses. Withdrawals for nonqualified expenses would result in the account owner's forfeiture of a proportionate amount of matching funds unless the withdrawn funds are re-contributed to the individual development account by the September 30 following the withdrawal.

The qualified entity administering the individual development account program would generally be required to make quarterly payments of matching funds on a dollar-for-dollar basis for the first $500 contributed by the account owner in a taxable year. This dollar amount would be adjusted for inflation after 2002. Matching funds may be provided also by State, local, or private sources. For account owners who attain age 61, matching funds would be deposited into the parallel account of the individual development account of the owner on the first day of the succeeding taxable year. Balances of the individual development account and parallel account would be reported annually to the account owner. If an account owner ceased to meet eligibility requirements, matching funds generally would not be permitted to be paid during the period of ineligibility. Any amount withdrawn from a parallel account shall not be includible in an eligible individual's gross income.

Qualified entities administering a qualified program would be required to report to the Secretary that the program is administered in accordance with legal requirements. If the Secretary determined that the program was not so operated, the Secretary would have the power to terminate the program. Qualified entities also would be required to report annually to the Secretary information about the number of individuals making contributions to individual development accounts, the amount of matching funds contributed, the amount of funds withdrawn and for what purpose, and balance information.

The Secretary would be required to submit to Congress annual progress reports on the status of qualified individual development programs. Within 12 months of the date of enactment, the Secretary would be required to develop a process to monitor the cost and outcomes of the qualified account programs. The Secretary would be authorized to prescribe necessary or appropriate regulations, including regulations providing rules to recapture credits claimed with respect to individuals who forfeit matching funds.

Effective date.--The bill would be effective for taxable years beginning after December 31, 2001. The credit would be effective for any expenditure made in any taxable year beginning after December 31, 2001, and before January 1, 2009, and with respect to any individual development account opened before January 1, 2007.