

[JOINT COMMITTEE PRINT]

DESCRIPTION OF S. 337 (RELATING TO  
CHARITABLE DEDUCTIONS BY  
NONITEMIZERS)  
AND S. 2017 (RELATING TO  
DEDUCTION FOR HOUSING EXPENSES OF  
MINISTERS AND MEMBERS OF THE  
UNIFORMED SERVICES)

SCHEDULED FOR A HEARING  
BEFORE THE  
SUBCOMMITTEE ON TAXATION AND  
DEBT MANAGEMENT  
OF THE  
COMMITTEE ON FINANCE  
ON SEPTEMBER 26, 1984

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### INTRODUCTION

The Subcommittee on Taxation and Debt Management of the Senate Committee on Finance has scheduled a public hearing on September 26, 1984, on S. 337 (introduced by Senators Packwood, Moynihan, Durenberger, Heinz, and others) and S. 2017 (introduced by Senators Helms, Jepsen, Exon, Cochran, Zorinsky, and Johnston). S. 337 would make permanent the charitable deduction for nonitemizers. S. 2017 would permanently exempt tax-free housing and subsistence allowances received by ministers or members of the uniformed services from the rule which disallows deductions for expenses allocable to exempt income.

This pamphlet, prepared in connection with the hearing, has two parts. The first part is a summary. The second part provides a description of the bills, including present law, issues raised by the bills, a description of the bills, and effective dates.

## I. SUMMARY

### S. 337—Senators Packwood, Moynihan, Durenberger, Heinz, and Others

#### Permanent Extension of Charitable Contributions Deduction for Nonitemizers

Present law allows a deduction for charitable contributions for both taxpayers who do and who do not itemize deductions on their Federal income tax return. The deduction for nonitemizers was added by the Economic Recovery Tax Act of 1981 and is subject to a phase-in over the years 1982-1986. The charitable contributions deduction for nonitemizers is scheduled to terminate on December 31, 1986.

The bill would make permanent the charitable contributions deduction for nonitemizers.

### S. 2017—Senators Helms, Jepsen, Exon, Cochran, Zorinsky, and Johnston

#### Deduction for Mortgage Interest and Taxes Allocable to Tax-free Allowances Paid to Ministers and Members of the Uniformed Services

Present law (Code sec. 265(1)) disallows a deduction for otherwise deductible amounts which are allocable to tax-exempt income. A 1983 IRS revenue ruling held that ministers are prevented by this rule from taking deductions for mortgage interest and real estate taxes on a residence to the extent such expenditures are allocable to tax-free housing allowances received by the ministers. A special transitional rule delayed application of this provision until January 1, 1985, for ministers who owned and occupied a home (or had contracted to purchase a home) before January 3, 1983. Under the Tax Reform Act of 1984, this transitional rule was extended until January 1, 1986. Neither the IRS ruling nor the 1984 Act referred to members of the uniformed services who receive tax-free housing and subsistence allowances; however, the IRS has indicated that it is studying application of the law to these cases.

The bill would permanently exempt tax-free housing and subsistence allowances received by ministers or members of the uniformed services from the disallowance rule.

## II. DESCRIPTION OF THE BILLS

### 1. S. 337 — Senators Packwood, Moynihan, Durenberger, Heinz, and Others

#### Permanent Extension of Charitable Contributions Deduction for Nonitemizers

##### *Present Law*

##### *Charitable contributions generally*

Subject to certain limitations, present law (Code sec. 170) provides an income tax deduction for contributions of money or property to or for the benefit of charitable organizations, the United States, and States or local governments. For contributions of capital gain property, the deduction generally is equal to the fair market value of the property on the date of the contribution. Charitable contribution deductions are also provided for estate and gift tax purposes.

Under present law, contributions of cash and ordinary-income property by an individual to public charities or private operating foundations are deductible up to 50 percent of the donor's contribution base for the year (equal to adjusted gross income with certain modifications). Contributions in excess of this limitation, or of a 30-percent limitation applicable to gifts by individuals of capital-gain property to such charities, may be carried forward and deducted over the following five years, subject to the applicable percentage limitations in those years.<sup>1</sup>

The Tax Reform Act of 1984 (P.L. 98-369) tightened the substantiation requirements applicable to charitable contributions of property and increased the penalty for incorrect valuation of donated property. As part of these changes, deductions for single items of donated property exceeding \$5,000 in claimed value (\$10,000 in the case of stock) are to be disallowed, under regulations issued before January 1, 1985, unless the taxpayer attaches a summary of an independent appraisal of the donated property to his or her return.

##### *Charitable deduction by nonitemizers*

Prior to the Economic Recovery Tax Act of 1981 (P.L. 93-34), a deduction for charitable contributions could be claimed by an individual taxpayer only as an itemized deduction from adjusted gross income on the taxpayer's return.

<sup>1</sup> The Tax Reform Act of 1984 (P.L. 98-369) made various changes in the rules regarding contributions to private nonoperating (i.e., grantmaking) foundations. Under the 1984 Act, deductions for contributions of cash or ordinary income property to private nonoperating (i.e., grantmaking) foundations are limited to 30 percent of the donor's contribution base. Special limitations also apply to contributions of capital gain property to such foundations.

The 1981 Act provided a deduction for charitable contributions made by individual taxpayers who do not itemize deductions on their income tax returns, to be phased in over a five-year period and then terminated after 1986 (Code sec. 170(i)). Under the phase-in, for taxable years beginning in 1982-84, the amount of contributions which nonitemizers were allowed to take into account was subject to a dollar cap; in addition, for the years 1982-1985, only a percentage of the amount of contributions otherwise deductible was to be allowed as a deduction for nonitemizers. These percentages and dollar caps are shown in the following table:

Year	Percent- age	Contri- bution cap
1982.....	25	\$100
1983.....	25	100
1984.....	25	300
1985.....	50	.....
1986.....	100	.....
1987.....	( <sup>1</sup> )	( <sup>1</sup> )

<sup>1</sup> Provision scheduled to expire.

Thus, in 1982 and 1983, nonitemizers were allowed to deduct 25 percent of the first \$100 of charitable contributions, for a maximum deduction of \$25, while for 1984, the maximum deduction is \$75 (25 percent of a \$300 contribution cap).<sup>2</sup>

For 1985 and 1986, nonitemizers may deduct 50 and 100 percent of their charitable contributions, respectively, without regard to a contribution cap (other than the general Code limitation to 50 percent or other applicable percentage of the taxpayer's contribution base). Under present law, no deduction is to be allowed for any charitable contribution by nonitemizers made after December 31, 1986.

The deduction for nonitemizers is subject to the tax rules generally applicable to charitable deductions, including the limitations on deductibility based on the donor's adjusted gross income and reductions in deductible amount for gifts to certain categories of donees or gifts of certain types of property. The charitable contribution deduction for taxpayers who do itemize deductions was not affected by the 1981 Act changes.

#### *Issues*

The proposal to make permanent the charitable deduction for nonitemizers raises several issues of tax policy and administration:

First, the proposal raises the issue of which taxpayers benefit from the deduction for charitable contributions, and what incentive for charitable giving is provided by that deduction. When any deduction (including the deduction for charitable contributions) is limited to taxpayers who itemize deductions, it has value only to

<sup>2</sup> The dollar caps shown in the table apply to single returns and joint returns; that is, the cap is not doubled for joint returns. For married taxpayers filing separately, the applicable cap is half the amount shown in the table.

taxpayers whose total deductions exceed their zero bracket amount (\$3,400 for joint returns and \$2,300 for single returns). This may tend to limit the deduction to wealthier taxpayers, who will also benefit more from the deduction because of their higher marginal rates. The legislative history accompanying the 1981 Act suggests that Congress extended the charitable contribution to nonitemizers in order to stimulate charitable giving by a broader section of taxpayers (i.e., taxpayers who did not benefit from itemizing as well as those who did).<sup>3</sup> However, it may be argued that the availability of the charitable deduction to nonitemizers provides a tax incentive primarily for small contributions, many of which would have been made regardless of the incentive; thus, the provision may result in revenue loss without a significant compensating benefit to charitable organizations.

Second, the bill raises the general policy of requiring itemization of personal deductions, and allowing such deductions only to the extent they exceed the zero bracket amount. This policy is generally intended to reduce the administrative burden on the IRS (and on taxpayers) by limiting the relevant deductions to those taxpayers having substantial deductions, while allowing other taxpayers to utilize the zero bracket amount. As part of this policy, taxpayers are generally prevented from claiming the benefits of both their personal deductions and the zero bracket amount (since the size of the zero bracket amount was set by Congress to reflect estimated charitable contributions and other itemized deductions). Allowing one specific deduction (i.e., the charitable deduction) to nonitemizers is contrary to this general policy and may create a precedent for further exceptions.

Third, the bill raises administrative problems regarding charitable contributions generally, including the problem of substantiating charitable gifts. These problems may be considerably increased by allowing charitable deductions for nonitemizers, since the IRS is required to audit both nonitemizing and itemizing taxpayers for charitable contributions and the nonitemizing taxpayers may, in some cases, be less aware of the applicable reporting and substantiation requirements. On the other hand, limiting the deduction to itemizers effectively punishes taxpayers for filing less complicated returns and may thus conflict with the goal of simplifying the return process.

Finally, if Congress does extend the charitable deduction for nonitemizers, it may wish to consider the possibility of limiting the amount of the deduction which may be claimed by nonitemizers and the period for which such deductions may be taken.

<sup>3</sup> See 127 *Cong. Rec.*, S7960-7971, July 20, 1981 (remarks on Senate floor amendment); Staff of the Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981*, p. 49 (December 29, 1981). Currently available IRS figures indicate that charitable deductions were claimed on approximately 22.3 million returns filed by nonitemizers for tax year 1983, for an aggregate of approximately \$590.0 million in deductions, a slight increase over 1982, the first year in which the deduction was allowed. The aggregate deduction figure reflects the \$25 limit per taxpayer which was in effect for 1983. (Figures supplied by IRS Statistics of Income Division, based on IRS individual master file for returns available through September 7, 1984.)

*Explanation of Provision*

The bill (S. 337) would make permanent the allowance of charitable contribution deductions by nonitemizers included in the 1981 Act and otherwise scheduled to expire on December 31, 1986. Thus, nonitemizers would be able to deduct 100 percent of charitable contributions in any taxable year beginning in 1987 or later years, subject to the general Code restrictions and limitations applicable to such contributions. The bill would not affect the present law treatment of charitable contributions by nonitemizers for taxable years beginning in 1985 (for which 50 percent of contributions are deductible under present law) or 1986 (for which 100 percent of contributions are deductible under present law).

*Effective Date*

The bill would be effective for contributions made after December 31, 1986.

2. S. 2017—Senators Helms, Jepsen, Exon, Cochran, Zorinsky,  
and Johnston

**Deductibility of Mortgage Interest and Taxes Allocable to Tax-free Allowances Paid to Ministers and Members of the Uniformed Services**

*Present Law*

*Disallowance of deductions related to tax-exempt income*

Present law (Code sec. 265(1)) disallows a deduction for amounts allocable to income (including interest or other forms of income) which is wholly exempt from tax under the Code. This provision applies (1) in the case of income other than interest income, to any otherwise allowable deduction, and (2) in the case of interest income, to amounts otherwise deductible as expenses for the production of income (sec. 212).<sup>4</sup>

Section 265(1) has most frequently been applied to disallow a deduction for expenses incurred in the production of tax-exempt income (e.g., expenses incurred in earning income on tax-exempt investments). However, the provision has also been applied in certain cases where the use of tax-exempt income is sufficiently related to the incurring of a deduction to warrant disallowance of that deduction. For example, section 265(1) has been held to disallow a deduction for that portion of a veteran's flight-training expenses which were reimbursed by the Veterans Administration under a tax-free educational allowance program (*Manocchio v. Commissioner*, 78 T.C. 989 (1982), *aff'd* 710 F.2d 1400 (9th Cir. 1983)).

*Application to ministers and members of the uniformed services*

In Rev. Rul. 83-3, 1983-1 C.B. 72, the IRS ruled that a minister may not take deductions for mortgage interest and real estate taxes on a residence to the extent that such expenditures are allocable to tax-free housing allowances provided to the minister under section 107 of the Code.<sup>5</sup> This ruling revoked a 1962 ruling which had taken a contrary position. The 1983 ruling also holds that section 265(1) does not allow a deduction for educational expenses allocable to tax-free scholarships or Veterans' Administration allowances.

The 1983 IRS ruling was generally applicable beginning July 1, 1983. However, for a minister who owned and occupied a home before January 3, 1983 (or had a contract to purchase a home before that date and subsequently owned and occupied the home),

<sup>4</sup> A deduction for interest used to purchase or carry tax-exempt obligations is disallowed under section 265(2) of the Code.

<sup>5</sup> Section 107 provides that gross income does not include (1) the rental value of a home furnished to a minister as part of his compensation, or (2) the rental allowance paid to a minister as part of his compensation, to the extent he uses the allowance to rent or provide a home.

the disallowance was not to apply until January 1, 1985 (IRS Ann. 83-100).

The Tax Reform Act of 1984 (P.L. 98-369) extended the transitional rule for ministers contained in Rev. Rul. 83-3 through January 1, 1986. Thus, for a minister who owned and occupied a home before January 3, 1983 (or had a contract to purchase a home before that date and subsequently owned and occupied the home), the disallowance of mortgage interest or real property tax deductions does not apply for expenses incurred before January 1, 1986. In the case of mortgage interest deductions, this transitional rule applies only to a mortgage which existed on January 3, 1983 (or which was entered into in connection with a contract to purchase a home before that date). The Act did not affect the 1983 ruling's general effective date of July 1, 1983.

Neither the 1983 IRS ruling nor the Tax Reform Act of 1984 affected the application of section 265(1) to members of the uniformed services. However, in December 1983, the IRS announced that it was studying whether members of the uniformed services are entitled to deduct mortgage interest and property taxes to the extent they receive tax-free housing allowances from the Federal Government. The IRS stated that any determination on this issue which adversely affected members of the uniformed services would not be applied to amounts paid before January 1, 1985 (IR News Rel. 83-161).<sup>6</sup>

#### *Issues*

A permanent exemption from the disallowance provision for ministers and members of the uniformed services raises a number of policy issues. Allowance of interest and tax deductions in such cases results in an effective double benefit to the individuals concerned, since they receive both tax-free support and a tax deduction (which may then be used to offset other income) as a result of the same activity. This result is inconsistent both with the specific policy of section 265(1) and the general policy of preventing double benefits under the Code. However, it may be argued that Congress, in exempting ministers' and servicemen's allowances from taxation, intended to create a special subsidy for such individuals, and should not limit this subsidy by denying a deduction for related expenses. In the case of servicemen, it is also arguable that, if these deductions are disallowed, the Federal Government will be forced to provide an equal, direct subsidy to servicemen in the form of increased subsistence and housing allowances; thus, the disallowance of deductions might produce little or no net gain to the Federal Government. On the other hand, the amount of the benefit derived from tax deductions varies with the marginal tax bracket of the taxpayer and, as a result, the revenue loss from allowance of the deduction for high marginal tax bracket taxpayers may be higher than a direct subsidy.

<sup>6</sup> A floor amendment by Sen. Helms, adopted by the Senate April 11, 1984, would have precluded application of the 1983 IRS ruling to ministers or members of the armed forces before January 1, 1986 (regardless of the date of purchase of the residence). However, the reference to members of the armed forces was subsequently deleted in conference.

Application of section 265(1) to ministers who purchased homes prior to 1983 raises a separate issue relating to transitional relief, since it can be argued that these homes were purchased on the assumption that interest and tax deductions would remain in force indefinitely. (The IRS has yet to reach a decision regarding application of section 265(1) to members of the uniformed services.) The Tax Reform Act of 1984 provides transitional relief for such cases through calendar year 1985; however, application of the disallowance rule in 1986 and later years may still result in hardship in some cases. If Congress wishes to provide additional relief in these cases, it may wish to consider a permanent extension of the transitional rule contained in the 1984 Act.

*Explanation of Provision*

The bill (S. 2017) would provide that section 265(1) is not to apply to income described in section 107 of the Code (i.e., tax-free housing allowances received by ministers), or to allowances described in 37 U.S.C. secs. 402 and 403 (relating to subsistence and housing allowances provided to members of the uniformed services). Thus, under the bill, mortgage interest and real estate taxes paid by ministers or members of the uniformed services<sup>7</sup> would be permanently exempt from the disallowance provision.

*Effective Date*

The bill would be effective for taxable years beginning after December 31, 1982. Because Rev. Rul. 83-3 was in any case not effective until July 1, 1983, this would effectively prevent application of the disallowance provision to mortgage interest and real estate taxes paid by ministers or members of the uniformed services at any time.

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<sup>7</sup> The uniformed services includes members of the armed forces, the National Oceanic and Atmospheric Administration, and the Public Health Service.