

**Do Tax Exemptions for Nonprofit  
Organizations and Charitable Giving Pay Off:  
A Cost-Benefit Analysis**

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# Financial Status of Nonprofits in the United States

- In 2012, just under 193,000 nonprofit “501(c)(3)” charitable organizations registered with the U.S. Internal Revenue Service.
  - Total revenue of U.S. nonprofits : \$1.7 trillion.
  - Total spending by U.S. nonprofits: \$1.6 trillion
  - Total assets owned by U.S. nonprofits: \$3.3 trillion
  - Total liabilities of U.S. nonprofits: \$1.3 trillion

# Tax Benefits Received by Nonprofits in the United States

- U.S. nonprofits benefit from several tax benefits
- **Income Tax Deduction** for Charitable Giving
  - Private Individuals (up to 50% of income)
  - Private corporations (up to 10% of corporate profit).
- **Income tax exemption** for most income received by nonprofits;
- **Local Property tax exemption** for property owned by many nonprofits

# Estimates of Tax Benefits Received

- U.S. nonprofits benefit from several tax benefits
  - Federal:
    - Charitable income tax deduction: **\$50 billion**
    - Income tax exemption: **\$ 40 billion**
  - State and local
    - Nonprofit property tax exemption: **\$90 billion**
- Federal + State and Local: **≈ \$200 billion**

# Criteria for Status as a Federal “Charitable Organization”

To be tax-exempt under section 501(c)(3) of the Internal Revenue Code, an organization must be [organized](#) and [operated](#) exclusively for [exempt purposes](#) set forth in section 501(c)(3), and none of its earnings may [inure](#) to any private shareholder or individual. In addition, it may not be an [action organization](#), *i.e.*, it may not attempt to influence legislation as a substantial part of its activities and it may not participate in any campaign activity for or against political candidates. Organizations described in section 501(c)(3) are commonly referred to as *charitable organizations*.

The organization must not be organized or operated for the benefit of [private interests](#), and no part of a section 501(c)(3) organization's net earnings may inure to the benefit of any private shareholder or individual. If the organization engages in an [excess benefit transaction](#) with a person having substantial influence over the organization, an [excise tax](#) may be imposed on the person and any organization managers agreeing to the transaction.

Section 501(c)(3) organizations are restricted in how much political and legislative (*lobbying*) activities they may conduct.

# Criteria for State and Local Property Tax Exemption

- Registration at state level as a nonprofit organization (similar criteria to federal)
- Provide “community benefit”
  - Broadly defined
  - Some controversy over definition

# Are the Tax Benefits Worth It? How the Charitable Deduction Works

- “Price” of \$1 charitable contribution
  - Without deduction: \$1
  - With deduction:  $\$(1 - t)$  where  $t$  is giver’s tax bracket
- Example:
  - Giver’s tax rate = 25%
  - After-tax, out-of-pocket price of contributing \$1 =  $\$(1 - .25) = \$0.75$

# Are the Tax Benefits Worth It?

## Charitable Deduction: II

- 2014 Revenue Cost: \$50B
- Case 1: Contributions perfectly inelastic with respect to out-of-pocket price
  - Benefit to charities:  $\Delta C = \$0$
  - Revenue Cost: \$50B
- Case 2: Contributions inelastic with respect to out-of-pocket cost:
  - Benefit to charities:  $\$0 < \Delta C < \$50B$
  - Revenue Cost: \$50B
- Case 3: Contributions elastic with respect to out-of-pocket cost:
  - Benefit to charities:  $\uparrow \Delta C \geq \$50B$
  - Revenue Cost: \$50B



# Price/Cost Sensitivity of Charitable Contributions

- Key parameter is the price elasticity of contributions with respect to the after tax cost of giving:

$$\varepsilon = \frac{\% \text{ Chng. in Contributions}}{\% \text{ Chng. in After Tax Cost of Giving}} = \frac{\frac{\Delta C}{C}}{\frac{\Delta(1 - \tau)}{(1 - \tau)}} = \frac{(1 - \tau)}{C} \cdot \frac{\Delta C}{\Delta(1 - \tau)} ;$$

$C$  = Contributions;  $(1 - \tau)$  = after tax cost of giving \$1;  $\tau$  = marginal tax rate

- Value of  $\varepsilon \geq 1$  threshold for “treasury efficiency” ( $\varepsilon$  expressed as an absolute value)

# How Sensitive is Charitable Giving to Its After-Tax Cost

- Many estimates, especially for the United States
  - Low end:  $\varepsilon = 0.5$
  - High end:  $\varepsilon = 1.5$
- Estimate from 1993 World Bank Data for Russia (Brooks, 2002)
  - $\varepsilon = 6.68!$

# Policy Assessment of Charitable Deduction

## “Pluses”

- Benefits delivered swiftly, cheaply
- Minimal amount of govt. involvement

## “Minuses”

- Poor targeting
- Tax system not always best administrative vehicle
- Increased demands placed on Treasury

# Nonprofit Income Tax Exemption: Is it Worth It

- Unlike charitable contributions there is no single “statistic” like the price elasticity of giving
- Carroll and Calabrese (2012)
  - Statistical evidence that spending on social services by nonprofits reduces tax burdens at the state level.
- Case-by-case Benefit-Cost studies of programs of individual non-profits

# Nonprofit Property Tax Exemption

- As in the case of nonprofit income tax exemption no single “benefit-cost” measure
- Much depends on whether the nonprofit receiving the property tax exemption provides community benefits that substitute for what local government would have to spend.
- Some local governments in the U.S. would like to limit the property tax exemption to those nonprofits that provide a “true” community benefit.

# Issues of Compliance and Fraud

- How can one ensure that a “nonprofit: is organized and operated exclusively for exempt (i.e. charitable) purposes set forth in section 501(c)(3), and none of its earnings may inure to any private shareholder or individual?
- Concern than nonprofits may become “for-profits in disguise”

# Compliance and Enforcement Mechanisms

- Formal legal mechanisms
  - IRS monitoring of organizations to limit abuse
  - Requires uses of scarce administrative resources
    - Don't collect tax revenue but instead monitor the behavior of exempt organizations
- Informal, private monitoring of behavior
  - “Watchdog” organizations that publish information about nonprofits
  - GuideStar: <http://www.guidestar.org/Home.aspx?gclid=Cl-yiKW8iskCFdePHwodrLAJLw>
  - Charity Navigator: <http://www.charitynavigator.org/>

# Are Tax Benefits for Nonprofits Worthwhile?

- Statistical evidence that charitable giving does respond to changes in the out-of-pocket cost
  - Implication: Government can leverage private response to increase private giving by more than \$1 for each \$1 of revenue lost
- Creation of a vibrant, financially healthy nonprofit sector.
  - A suggestive statistic: U.S. has most generous tax incentives for charity, and also has the highest giving as a proportion of GDP (1.67%) compared to: United Kingdom (0.73%), Australia (0.69%), and Germany (0.22%)



# Some References

- Arthur Brooks, 2002. “Charitable Giving in Transition Economies: Evidence from Russia.” *National Tax Journal* 55(4): 743-753.
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- Economist, 2012. “Sweetened Charity.” June 9, 2012.