



**Testimony of  
Diana Aviv  
President and CEO  
Independent Sector**

**United States Senate  
Committee on Finance  
Hearing on  
Outside the Box on Estate Tax Reform: Reviewing Ideas to Simplify Planning  
April 3, 2008**

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## Senate Committee on Finance

### Testimony of Diana Aviv President and CEO Independent Sector April 3, 2008

Chairman Baucus, Ranking Member Grassley, and Members of the Committee:

Thank you for this opportunity to appear before you today. It's an honor to provide a perspective from our nation's nonprofit community, and to discuss the implications of changes to the estate and gift tax system for the services nonprofits provide to enrich lives and strengthen communities across the nation and around the world.

I am Diana Aviv, president and CEO of Independent Sector, a national, nonpartisan charitable organization with approximately 600 members, including public charities, private foundations, and corporate giving programs, collectively representing tens of thousands of charitable groups in every state across the nation. Our coalition leads, strengthens, and mobilizes the charitable community to fulfill our vision of a just and inclusive society and a healthy democracy of active citizens, effective institutions, and vibrant communities. IS members represent a broad cross-section of our nation's nonprofit community, which exists to improve society, frequently in partnership with government, in diverse areas such as health care, education, human services, the arts, and community development.

My testimony today will focus on two themes: the impact of the estate tax on charities, and areas of potential abuse that the Committee should evaluate. America's charities and foundations are created and sustained by people who want to give their time and resources to solve problems and enrich their communities. Americans are motivated to give because of their compassion for those in need, their desire to advance a particular cause, or sometimes, simply because they have been asked. Whatever the motivation for giving, research has shown that tax policy has a considerable impact on when, to whom, and how much Americans give, particularly if they are in higher economic brackets.

Estate tax policy strongly encourages Americans to give back to their communities both during their lifetimes and through their estates. The estate tax also provides significant revenues to support government-funded programs that are vital to sustaining healthy communities and the well-being of Americans of all ages. Many of these programs are delivered through, or in partnership with, charitable organizations and would not be possible without the combination of the public and private support that our tax system facilitates. As Congress considers the best ways to structure the estate tax system going forward, we urge you to ensure that it continues to encourage Americans to give back to their communities through charitable contributions and that it protects the ability of both federal and state government to provide vital services.

As with any tax system, the estate tax can be manipulated by unscrupulous individuals to provide inappropriate financial benefits to themselves and their family members. Independent Sector has stood with this Committee in your work to identify and punish those who abuse charitable resources for their personal gain and to encourage charitable organizations to institute effective practices to prevent such abuses. We believe this same vigilance should be applied to the oversight and

enforcement of the tax laws as they apply to estates and to vehicles for lifetime giving that allow taxpayers to avoid their appropriate tax obligations.

## **The Estate Tax and Charitable Giving**

America's nonprofit community now encompasses more than 1.5 million organizations, large and small, that engage people in securing basic needs, creating opportunities, offering hope, fostering creative expression, and nurturing our spirits. These organizations produce results because of the commitment and talent of the people who have dedicated their lives to helping others. While funding sources for individual organizations varies substantially, the majority of support for the work of the community as a whole comes from consumers of services and voluntary contributions: 38 percent from dues, fees, and other charges for goods and services, 17 percent from individual contributions, and an additional 3 percent from private foundations and corporate giving programs. Government grants and contracts provide 31 percent of the community's revenues, and other sources, such as income from assets, supply the remaining 11 percent.

Congress and state legislatures have long recognized the special importance of the work of charitable nonprofits and have encouraged the American people to support this work by allowing taxpayers to deduct charitable contributions when calculating their income taxes, subject to specific allowances and rules. Congress has provided even greater motivation for Americans to give back to their communities through their estates by permitting unlimited deductions for charitable contributions when calculating estate taxes. Americans can choose to leave their entire estates to charity thus eliminating all estate tax liability.

These incentives have had a significant influence on the how – and how much – Americans give to support charitable causes. The Congressional Budget Office found that the estate tax leads affluent people to donate far more than they otherwise would, because such donations—whether made during life or as bequests at death—sharply reduce estate tax liability.<sup>1</sup> The CBO found that about one-sixth of the estates filing estate tax returns in 2000 left a charitable bequest which together totaled \$16 billion. Charitable bequests were heavily concentrated in the largest estates with over 70 percent of the total bequests coming from estates valued at more than \$3.5 million.

The CBO further estimated that if the estate tax had not existed in 2000, donations to charities would have been reduced by \$13 billion to \$25 billion, which is more than the total amount of corporate donations in that year. For example, if a potential donor's assets would be subject to a 45% estate tax rate, then a charitable bequest of \$1 million would reduce the tax liability of the estate by \$450,000. The unlimited deduction for charitable giving provides a valuable incentive for the wealthiest of our citizens to give back to the communities in which they have lived and earned success.

If Congress were to repeal the estate tax or significantly reduce estate tax marginal rates, the significant decline in charitable donations from wealthy Americans forecast by the Congressional Budget Office study would have damaging effects on the nonprofit community and on society as a whole. Donations from individuals, including bequests, make up 84% of all contributions, constituting one-sixth of the total support for charitable nonprofits. Moreover, about two-thirds of all contributions by individuals in 2000 were made by people with a net worth high enough to

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<sup>1</sup> Congressional Budget Office, *The Estate Tax and Charitable Giving*, July 2004.

potentially face the estate tax. If nonprofit groups lost a substantial part of these donations, many of them would have to scale back their activities significantly.

## **Impact of the Estate Tax on Government Revenues**

While tax policy provides critical incentives to encourage charitable giving, the most fundamental reason for the estate tax, or any tax, is to provide government with the resources it needs to meet important public priorities. Economists and forecasters across the political spectrum, as well as respected international bodies like the International Monetary Fund, agree that the nation faces devastating long-term fiscal problems as the baby boomers age and need increased health care. Deficits are on course to reach economically unsustainable magnitudes unless strong action is taken. Permanently repealing or significantly reducing the estate tax would dig the deficit hole even deeper, jeopardizing the viability of numerous programs and services that are relied upon by millions of Americans every day.

Repeal of the estate tax would result in a loss of roughly \$522 billion over five years<sup>2</sup> and \$1 trillion in lost federal tax revenues over a ten-year period.<sup>3</sup> The magnitude of this loss of revenue should be viewed in the context of budget realities. President Bush's proposed FY 2009 budget called for cuts to entitlement spending totaling \$208 billion over five years and eliminating or reducing 151 programs to reach a savings of only \$18 billion. A projected loss in federal revenue of \$1 trillion over a 10-year period would mark the end of countless discretionary programs that serve all Americans, not just the neediest, as well as severely damage the capacity of the federal government to provide healthcare and other benefits to a growing number of retiring baby boomers. We would undoubtedly see deep cuts in federally funded programs vital to the people served by the nonprofit community, including education, the arts, health care, and especially aid for poor and vulnerable people, as well as elimination of community development grants, first responder funding, and entrepreneurship grants.

Elimination of the estate tax would also harm state budgets, many of which have their own estate tax linked to the federal.<sup>4</sup> Current estimates by the Center on Budget Policy Priorities indicate that at least 28 states face immediate fiscal crises and 17 of those have made or are considering budget cuts that threaten vital services in order to achieve balance.<sup>5</sup> Further loss in revenue would cripple restructuring efforts and may extend the threat of budget collapse to the remaining states, including those that have just barely recovered from fiscal crisis earlier this decade. Eventually, the budget squeeze will be felt the hardest at the local level for community programs that find critical government support dried up, diminishing their capacity to structure services tailored specifically to meet the diverse needs of their constituencies.

All of these challenges impact the charitable community in many ways. Organizations that rely on grants and contracts from federal, state, and local governments to provide services have been affected by cuts and changes in funding priorities. In recent years, we have witnessed a decrease in

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<sup>2</sup> CBPP – “The Dubious Priorities of the President’s Budget” – Robert Greenstein, James Horney, Richard Kogan – February 7, 2008

<sup>3</sup> CBPP – “The Estate Tax – Myths and Realities” – October 11, 2007

<sup>4</sup> “A Compromise on the Estate Tax” – *The Chronicle on Philanthropy* – Diana Aviv and Robert Greenstein – November 11, 2004

<sup>5</sup> “Facing Deficits, Many States Are Imposing Cuts that Hurt Vulnerable Americans” – CBPP – Iris Lav and Elizabeth Hudgins – March 13, 2008

the absolute dollar amounts (not just inflation-adjusted dollars) in the federal budget for non-defense domestic discretionary programs vital to the sector. Indeed, spending on non-defense discretionary services outside of homeland security has declined both as a share of the total federal budget and of the nation's economy. There have also been changes in the dollars allocated for and funding formulas for mandatory programs that affect services for needy individuals and families, raising the demand for services provided by charitable organizations.

To summarize, the estate tax provides a stream of funding that is essential to the work of charities in enhancing life and to the work of government and its priorities. We urge the Committee to consider these factors as it addresses the future of the estate tax.

### **Abuses Involving Charities**

Independent Sector opposes all schemes that provide inappropriate financial benefits to donors and their families as a result of their arrangements with or donations to charity as part of estate planning or lifetime giving. The nonprofit community has a sound record for self-evaluation and of taking action to promote tax compliance. IS has strongly supported the efforts of this Committee and those of Chairman Baucus and Ranking Member Grassley to investigate and expose sham transactions involving unscrupulous individuals and charities. We have fully endorsed the use of the severest remedies under law to penalize all willing participants to abusive transactions involving the contribution of non-cash property to charity. Whether the wrongdoers are tax shelter promoters, appraisers, donors who overstate their deductions or receive inappropriate benefits, or officials at tax-exempt organizations who knowingly participate in fraudulent schemes, it is our position that they must be punished for the sake of the nonprofit community as a whole.<sup>6</sup> Here today, we reaffirm our support for your commitment to addressing potential tax law abuses in the nonprofit community, particularly those related to the transfer of estate-related assets.

At the encouragement of this Committee four years ago, Independent Sector convened the Panel on the Nonprofit Sector to perform what constituted the most comprehensive review of the governance, regulations, and operations of the charitable community in more than three decades. The Panel, composed of 24 nonprofit and philanthropic leaders, ultimately prepared a series of recommendations for Congress to improve the oversight and governance of charitable organizations and for individual nonprofit organizations to ensure high standards of ethics and accountability. In June 2005, the Panel presented its Final Report to Congress and in April 2006, it released a Supplemental Report.<sup>7</sup>

Together these reports contain a strong, carefully integrated package of over 130 recommendations for actions that lawmakers, the IRS, and the sector itself could take to improve the accountability and tax-law compliance of charitable organizations. The Panel identified areas of misconduct that were not covered by existing law. The Panel also recommended methods for strengthening existing law enforcement systems to facilitate a more streamlined use of resources.

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<sup>6</sup> See, e.g., Letter to Chairman Baucus and Ranking Member Grassley regarding Sham Transactions Based on Inflated Property Values, June 21, 2007, [Independent Sector | Newsroom - IS Endorses Senate and Treasury Efforts to Eliminate Sham](#)

<sup>7</sup> A third Panel report dealing with self regulation, *Principles for Good Governance and Ethical Practices: A Guide for Charities and Foundations*, was released in October 2007.

In the year following the release of the two reports, Independent Sector and many other nonprofit organizations consulted with Senators and Members of Congress, encouraging them to enact legislation implementing the Panel's recommendations. The result was the package of legislative reforms passed by Congress as part of the Pension Protection Act of 2006 and signed into law in August 2006. Those reforms included increased fines and penalties for violations of prohibitions on excessive private benefits, clearer rules for appraisals required to substantiate tax deductions for charitable contributions, and new rules to ensure that assets held in donor-advised funds and supporting organizations are used to benefit the intended charitable purposes. These reforms represent the most comprehensive change to the laws governing charitable organizations since the 1969 Tax Act and have significantly strengthened the legal framework that enables our charitable community to be a vital resource for our nation.

The reforms in the Pension Protection Act, while necessary and important, cannot eradicate all instances of abuse involving charitable donations. Recently, the IRS released its 2008 list of the 12 most egregious tax schemes and scams. The so-called "Dirty Dozen" includes among its numbers a section on abuse of charitable organizations and deductions. Identified misuse includes tax shelters, attempts by donors to maintain control over donated assets, income from donated property, and overvaluation of contributed property.<sup>8</sup> Independent Sector and its members share the concerns of the IRS that improper schemes continue and are working to educate the nonprofit community on strong self-governance principles and tax-law compliance.

### **Potential for Estate Tax Abuse**

All of us recognize that illegal conduct involving donations to charities hurts all donors, the charities themselves, and the people they serve. This Committee has previously publicized fraudulent schemes involving deductions for property donations to 501(c)(3) organizations, with violations including improper return benefit to the donor, improper retention of a partial interest in donated property, inflated valuation, and possible permissible private benefit on the part of 501(c)(3) organizations that participated in the transactions. We recognize that in principle as well as practice, variations of these infractions have the potential for proliferating in relation to the estate tax.

Estate planning is a beneficial and essential tool for aiding American citizens in protecting and properly transferring their assets following their deaths. Wealthy Americans frequently retain competent professionals to plan and manage their estates, regardless of tax-law consequences, because their affairs can be extremely complicated.

We recognize that there are opportunities in the law that can be exploited to time gifts and remainders to benefit estate transferees in ways that were not contemplated by Congress and should be reconsidered. To the extent that schemes are being designed to provide inappropriate benefits to heirs through gifts to charitable organizations, these practices should be uncovered and stopped. Our attention has recently been directed to the complex estate planning device known as the "charitable lead trust" (CLT) as an area of potential abuse. These estate-planning tools are very popular in the nonprofit community because they can generate considerable charitable giving to a wide array of organizations and serve to benefit the people and communities where they operate. A CLT allows individuals to put a sum of money into a trust which will donate an annual stream of

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<sup>8</sup> IRS Dirty Dozen List, IR-2008-41, March 13, 2008.

revenue to a charity for a ascertainable period of time (e.g., life of the donor, number of years) and pass any left over assets, known as the remainder, to named beneficiaries. The plans are advertised to potential donors as a “powerful tool,” as a device that results “in little or no taxes,” and more.

The inducement is that a CLT permits an individual to pass on substantially appreciated assets without paying additional gift or estate taxes.<sup>9</sup> The reason is the method by which the Internal Revenue Code calculates the benefits and liabilities under CLTs. An individual’s tax liability is assessed at the time of the transfer of assets into the trust. Rather than permitting a charitable tax deduction for each year that it is received by the charity, the law requires that the present value of the entire donation be calculated up front. Any amount left over after subtracting this present-value calculation is considered the “remainder” for the beneficiaries and taxed at the date of transfer at the appropriate gift tax rate.

Consider, for example, an individual who deposits \$1 million in a 20-year charitable lead trust, and stipulates that the charity is to receive \$70,000 in income annually, with the remainder going to his sons and daughters. Using the statutory interest rate of 120% of the Federal Midterm Rate, the Treasury tables project the value of the donation as \$777,500 and the remainder as \$222,500, which is then taxed accordingly. In this example, the trust principle actually grows to about \$2.5 million because actual investment performance far outpaces the statutory rate (which was 3.6% for March 2008). Since the statutory interest rate is so low and the projected value of the remainder has already been taxed, the heirs receive over \$2 million free of estate or gift taxes.

In certain circumstances, the donor can take a charitable deduction from income taxes when the assets are transferred into the trust. Charities may never receive the full amount of that donation if the funds in the trust are poorly managed and the rate of return falls below the statutory discount rate. When this happens, the funds run out before the promised donations are ever received, but the donor will have already received the full benefit of the deduction.

## **Proposed Reforms**

There are a number of ways in which the nonprofit community and the government may work closely to deter any ongoing and future abuses associated with estate planning and charitable organizations, including adequate funding for Internal Revenue Service enforcement programs, improved reporting mechanisms and requirements, and reform of donation vehicles.

### ***1. IRS Funding***

First, Congress should ensure that the IRS has sufficient resources to maintain a strong oversight and investigation program to enforce compliance by all taxpayers. We also believe that stronger oversight and education of charitable organizations are central to enhancing compliance with the law and ultimately increasing the ability of charities to improve lives. Research indicates that a healthy Internal Revenue Service enforcement budget could help to narrow the nation’s tax gap and ultimately reduce the federal deficit. We applaud the continued dedication of Congress to support increased funding for IRS services.

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<sup>9</sup> Generation-skipping taxes may still apply.

## ***2. Enhanced Compliance through Electronic Filing of Tax Returns***

The Internal Revenue Service has a daunting job in rooting out fraudulent conduct, a problem made more difficult because of the lack of electronic filing of many tax returns and the need to perform “paper searches” in order to find the truth. Electronic filing of the annual information returns filed by nonprofit organizations and of estate tax returns would permit both federal and state regulators to devote a greater portion of their limited resources to oversight, education, and enforcement instead of cumbersome, costly manual processing of paper returns.

Electronic filing is also likely to increase compliance with reporting requirements by providing immediate feedback on incomplete and potentially inaccurate information before returns are filed. Electronic filing software provides organizations with immediate checks on incomplete and potentially inaccurate information before they file returns, and e-filing also allows the IRS to reject and provide immediate feedback to organizations about incomplete returns and those with obvious inaccuracies.

The annual information return (Form 990) filed by nonprofit organizations serves as the primary document providing information about an organization’s finances, governance, operations, and programs for federal regulators, the public, and many state charity officials. This past December, the IRS released its redesigned Form 990 which many tax-exempt organizations must file annually and make available to the public. The revised Form 990 incorporates numerous changes recommended by the Panel on the Nonprofit Sector. Independent Sector believes the revised form will facilitate accurate, complete, and consistent reporting by exempt organizations, will be easier for most entities to complete, and improve public understanding of how organizations operate. We consider the new Form 990 a major step forward in accomplishing the nonprofit community’s goals of accountability and transparency.

Currently, the IRS does not have the statutory authority to require electronic filing of the Form 990 by organizations that submit fewer than 250 returns (including W-2s and other forms). The Internal Revenue Code should be amended to allow the IRS to require electronic filing by all organizations that file at least five tax forms per year.

Similarly, Congress should amend the tax code to permit the IRS to require electronic filing of IRS Form 706, the form that an executor of a decedent’s estate is required to file to determine estate tax liability. Under the current filing regime, the IRS must compare paper returns of estates and charities to investigate whether wrongdoing has occurred. Electronic filing of the 706 returns would allow the IRS to identify quickly missing or incomplete information and apply electronic diagnostics to flag potential discrepancies. As with the Form 990, Independent Sector supports examination and reform of the Form 706 to require electronic filing as a method for increasing accuracy and permitting more direct oversight.

## ***3. Charitable Lead Trusts***

As stated previously, charitable lead trusts are a valuable and popular tool for estate planning that allows individuals to give back to their communities while providing for their families after death. For charities throughout the country, the resources from CLTs have allowed them to pursue their missions of improving lives and transforming communities. The fundamental concept of the estate-planning tool is sound.



The current statutory formula and timing for calculating tax liability, however, appear to create the potential for overstated charitable deductions or understated tax liability for beneficiaries. We believe the Committee should review the current law to determine whether the statutory rate should be revised as it applies to CLTs. In the alternative, the Committee could consider changing the date at which tax liability is determined. Rather than estimating income and gift/estate tax liabilities at the time of transfer to the charitable lead trust, the tax consequences of the donations could be determined when they are actually received. This would mean that the charitable deduction would be available for each year in which a payment is made to the charity, and the tax liability for the remainder would be determined when the beneficiaries actually receive it at the end of the trust period. In each instance, the calculations would be based on fact rather than estimations. In the case of underperforming trust assets, this approach would also serve to ensure that charitable deductions are not taken for promised donations that never materialize.

## **Conclusion**

Independent Sector is committed to encouraging the nonprofit community to meet the highest standards of ethical practice, and we stand ready to work with policymakers and the IRS to educate charities and foundations about various tax schemes and help prevent their spread. While the threat of fraud will remain even after estate tax abuses are properly addressed, an overwhelming majority of nonprofit organizations will continue to live by the letter and the spirit of the tax law. Maintaining that standard depends on a combination of active self-regulation and effective enforcement of the tax law, and our community recognizes that we must demonstrate to stakeholders that we operate ethically and accountably, since only then will we receive the public support that enables us to serve communities everywhere.