CBO PAPERS

THE POTENTIAL EFFECTS OF TAX RESTRUCTURING ON NONPROFIT INSTITUTIONS

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CONGRESSIONAL BUDGET OFFICE

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SECOND AND D STREETS, S.W.
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NOTE

Numbers in the text and tables of this paper may not add up to totals because of rounding.

PREFACE

This paper assesses the potential effects of tax restructuring on nonprofit institutions. Written at the request of the Chairman of the Senate Budget Committee, it looks at the makeup and tax treatment of nonprofit institutions under current law and analyzes how provisions in recent proposals for tax restructuring could affect their operations.

Most of the proposals would lower tax rates and, in some cases, impose a single uniform, or "flat," rate. Most would also involve switching from an income-based to a consumption-based tax system—an objective that could entail enactment of a national retail sales tax, a value-added tax, or a variety of direct taxes on individual consumption. Proposals introduced in the 104th Congress exemplify each of those approaches, with varying implications for nonprofit institutions.

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SUMMARY AND INTRODUCTION

In recent years, several Members of the 103rd and 104th Congresses have introduced proposals to restructure the tax system. Most of the proposals would replace the current system, which is based primarily on income, with one that is based either wholly or partially on consumption. Most of the restructuring plans would also lower tax rates and cut back sharply on current tax preferences, including those that favor nonprofit institutions. The preferences that benefit nonprofit institutions the most are exemption from paying taxes, deductibility of charitable contributions from individual and corporate income, and eligibility to use proceeds from tax-exempt bond issues to raise capital, which makes it possible for the institutions to borrow funds at below-market interest rates.

Like income taxes, consumption-based taxes can be levied on businesses or individuals. Many of the current proposals would replace the corporate income tax with a value-added tax or some variant of it. Although most of those proposals would provide tax-exemption either for some or all nonprofit corporations, as defined in current law, the benefits of tax exemption would be more limited than now. Moreover, the nature of the proposals is such that current provisions permitting corporations to deduct charitable contributions from their income would no longer apply.

Among the proposals for taxes levied on individuals, some would retain the deduction for charitable contributions; others would not. Similarly, some would maintain the tax-exemption for interest on bonds issued by state or local government agencies on behalf of charitable institutions. Other proposals would eliminate that tax exemption—either directly or by excluding all interest income from the tax base, thus obliterating the distinction between taxable and tax-exempt notes and bonds.

Limiting the benefits of tax-exemption, reducing the incentive for individuals and corporations to make charitable contributions, and removing the tax advantage for bonds issued on behalf of charitable institutions could decrease the income that nonprofit organizations have available to meet their operating and capital expenses. The magnitude of that effect is uncertain, however, and it would not be uniform among the various proposals. A few would retain most of the tax preferences in current law and thus would have minimal consequences, particularly for those nonprofit institutions that current law designates as charitable, religious, educational, scientific, or literary.

The effects of some of the other proposals are likely to vary by type of institution. For example, churches and synagogues depend heavily on donations and receive them from a broad spectrum of income classes, including people who do not itemize their deductions and thus do not benefit from the preferential treatment of charitable contributions under current law. Other institutions, such as museums, are more dependent on large gifts from wealthy donors, who generally itemize their deductions and therefore might be more sensitive to changes in tax law that affect charitable contributions. By contrast, institutions such as hospitals that derive most of their income from service charges and fees and that have access to credit markets might be more sensitive to changes in law that affect their tax-exempt status and ability to benefit from tax-exempt financing.

Whatever their extent, the effects that the proposals might have on nonprofit institutions would essentially be a byproduct of tax restructuring. The primary objectives of restructuring are to simplify the tax system, encourage saving, and lower tax rates without also reducing revenues. Those objectives require broadening the tax base. A consumption-based tax system could be designed to provide preferential treatment for nonprofit institutions, although the mechanisms for doing so might differ from those under current law and, in some cases, might pose conceptual or technical problems. But regardless of whether the tax base was income or consumption, the trade-off for providing preferences would be higher tax rates and a more complex, less efficient tax system. The fundamental issue for policymakers is how to balance social- and tax-policy objectives. And that issue centers not on the tax base, but on the rationale for exempting institutions from taxation and the costs and benefits of subsidizing charitable activity.